



Financial Statements  
June 30, 2016

**South Dakota Retirement System,  
South Dakota Retirement System  
Supplemental Retirement Plan, and  
South Dakota Retirement System  
Special Pay Plan**

**SOUTH DAKOTA RETIREMENT SYSTEM,  
SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN,  
SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN**

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## **Independent Auditor's Report**

To the Board of Trustees  
South Dakota Retirement System  
Pierre, South Dakota

### **Report on the Financial Statements**

We have audited the accompanying financial statements of the South Dakota Retirement System (SDRS), which comprise the statement of fiduciary net position as of June 30, 2016, and the related statement of changes in fiduciary net position, for the year then ended, and the related notes to the financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective statement of the fiduciary net position of the South Dakota Retirement System, as of June 30, 2016, and the respective statement of changes in fiduciary net position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

**Change in Accounting Principle**

As discussed in Note 2 to the financial statements, SDRS has adopted the provisions of GASB Statement No. 72, *Fair Valuation Measurement and Application*, which has resulted in additional footnote disclosures. Our opinion is not modified with respect to this matter.

**Emphasis of Matter**

As described in Note 2 to the financial statements, the financial statements include investments valued at \$2,612,356,121 (24.85% of net position) whose carrying values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners. Our opinion is not modified with respect to this matter.

**Other Matters****Required Supplementary Information**

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis and the required supplementary information on pages 4-7 and 32-39 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

**Other Information**

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the SDRS's basic financial statements as a whole.

The additional supplementary information listed as supplemental schedules in the table of contents are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the accompanying financial information listed as supplemental schedules are fairly stated, in all material respects, in relation to the basic financial statements as a whole.



**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated October 19, 2016, on our consideration of SDRS's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering SDRS's internal control over financial reporting and compliance.

A handwritten signature in black ink that reads "Eide Bailly LLP". The signature is written in a cursive, flowing style.

Boise, Idaho  
October 19, 2016

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Management's Discussion and Analysis**

June 30, 2016

This section presents management's discussion and analysis of the South Dakota Retirement System's (SDRS or the System) financial position and performance as of and for the year ended June 30, 2016. This section is intended to supplement the SDRS financial statements and should be read in conjunction with the remainder of the SDRS financial statements.

#### **Financial Highlights**

- The fiduciary net position of SDRS decreased by \$263.1 million during fiscal year 2016. This decrease was primarily due to the investment performance of 0.3%, which was significantly below the assumed rate of 7.25%.
- SDRS paid \$487.1 million to SDRS benefit recipients in fiscal year 2016 compared to \$456.3 million in 2015. SDRS received \$228.5 million in SDRS member and employer contributions in fiscal year 2016 compared to \$219.7 million in 2015.

#### **Overview of the Financial Statements and Accompanying Information**

The basic financial statements consist of:

##### ***Financial Statements***

The System presents the statement of the fiduciary net position as of June 30, 2016 and the statement of changes in fiduciary net position for the year then ended. These statements reflect resources available for the payment of benefits as of the year-end and sources and uses of those funds during the year.

##### ***Notes to Financial Statements***

The notes to financial statements are an integral part of the financial statements and provide additional detailed information and schedules. Information in the notes provides disclosures concerning SDRS's organization, contributions and reserves, investments, the use of derivatives and securities lending, and other information.

##### ***Supplemental Information***

In addition to this discussion and analysis, the required supplemental information consists of four schedules of trend data and related notes concerning the funded status of SDRS, changes in net pension asset, investment returns, actuarial assumptions, and employer contributions.

Other supplementary schedules include detailed information on administrative expenses incurred by SDRS and a breakout of investment manager fees.

##### ***Financial Analysis***

SDRS is a cost-sharing, multiple-employer public employee retirement system. SDRS provides retirement, disability, and survivor benefits for employees of the state of South Dakota and its political subdivisions. The benefits are funded through member and employer contributions and investment income.

SDRS benefits are based on the members' final average compensation, their years of credited service, and a benefit multiplier and are payable for life with a 60% survivor benefit.

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Management's Discussion and Analysis**

June 30, 2016

A summary of the fiduciary net position is shown below:

#### **Summary of Fiduciary Net Position**

June 30, 2016 and 2015

	<b>2016</b>	<b>2015</b>
<b>Assets:</b>		
Cash and cash equivalents	\$ 6,915,822	\$ 6,807,072
Receivables	56,291,108	28,322,333
Investments, at fair value	10,494,761,258	10,757,834,674
Other assets	1,801,903	1,064,953
<b>Total assets</b>	<b>10,559,770,091</b>	<b>10,794,029,032</b>
<b>Liabilities:</b>		
Accounts payable and accrued expenses	2,123,716	2,730,400
Unsettled investment purchases	26,685,838	11,263,148
Due to brokers – futures transactions	17,498,410	3,501,869
<b>Total liabilities</b>	<b>46,307,964</b>	<b>17,495,417</b>
<b>Net position restricted for pension benefits</b>	<b>\$ 10,513,462,127</b>	<b>\$ 10,776,533,615</b>

#### **Change in Fiduciary Net Position**

Additions to the fiduciary net position include member and employer contributions and net investment income. The fixed member and employer contribution rates are established by law. On an annual basis, an independent actuarial valuation of SDRS is made to determine the adequacy of the fixed contribution rates to pay the normal cost of benefits, expenses, and amortize the unfunded actuarial accrued liability. In addition to the fixed contributions, members and employers may make additional contributions to purchase uncredited prior service. These purchase or acquisition payments are also included as contributions. As the SDRS membership ages, the number and amount of purchases have grown.

Income from investments is the other primary source of revenue for SDRS. The actuarial assumed investment rate is 7.25% at June 30, 2016. The net investment returns were 0.3% for 2016 and 4.18% for 2015.

Deductions from fiduciary net position are primarily benefit payments. During 2016, SDRS paid \$487.1 million to benefit recipients or 6.7% more than 2015. The increase is due to the annual 3.1 percent cost-of-living adjustment and additional annuitants. Refunds of accumulated contributions during 2016 decreased 10.5 percent. Administrative costs of SDRS increased 0.9 percent during 2016.

## SOUTH DAKOTA RETIREMENT SYSTEM

### Management's Discussion and Analysis

June 30, 2016

A summary of the changes in fiduciary net position is shown below:

	<u>2016</u>	<u>2015</u>	<u>Percentage change</u>
Additions:			
Employee contributions	\$ 114,443,295	\$ 110,152,580	3.9%
Employer contributions	114,090,075	109,549,977	4.1
Investment income	<u>22,836,265</u>	<u>435,682,659</u>	<u>(94.8)</u>
Total additions	<u>251,369,635</u>	<u>655,385,216</u>	<u>(61.6)</u>
Deductions:			
Benefits	487,053,001	456,297,424	6.7
Refunds of contributions	23,443,481	26,197,447	(10.5)
Administrative expenses	<u>3,944,641</u>	<u>3,911,222</u>	<u>0.9</u>
Total deductions	<u>514,441,123</u>	<u>486,406,093</u>	<u>5.8</u>
Net change in net position	(263,071,488)	168,979,123	(255.7)
Plan net position restricted for pension benefits:			
Beginning of year	<u>10,776,533,615</u>	<u>10,607,554,492</u>	<u>1.6</u>
End of year	<u><u>\$ 10,513,462,127</u></u>	<u><u>\$ 10,776,533,615</u></u>	<u><u>(2.4)%</u></u>

### Investments

SDRS investment portfolio management is the statutory responsibility of the South Dakota Investment Council. The South Dakota Investment Office is the primary investment manager, but the Investment Council may utilize the services of external money managers.

Net investment performance during 2016 and 2015 was 0.3% and 4.18%, respectively.

The Investment Council is governed by the prudent-man standard, as defined in South Dakota Codified Law §4-5-27:

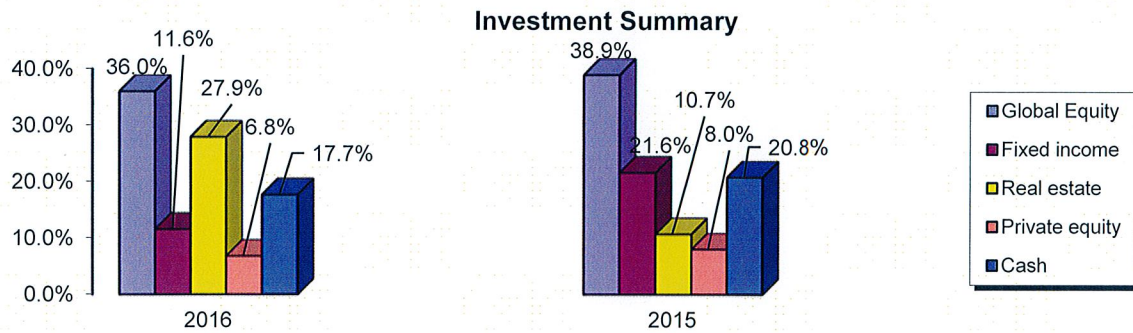
§4-5-27. Prudent-man standard required in investments. Any investments under the provisions of §4-5-12 to §4-5-39, inclusive, shall be made with the exercise of that degree of judgment and care, under circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived.

Though monthly benefit payments exceed monthly contributions, the SDRS is not subject to sudden, substantial, and unexpected withdrawals. As a result, it is not necessary to maintain a high percentage of assets in short-term investments unless that is deemed to be the best investment strategy. This allows the SDRS trust fund to be fully invested in a diversified portfolio of securities.

## SOUTH DAKOTA RETIREMENT SYSTEM

### Management's Discussion and Analysis

June 30, 2016



#### Plan Status

While the markets have not always made it possible to achieve the long-term assumptions, the System's funding remains solid. The reserve for long-term benefit goals has provided a process for both improving benefits and protecting the System in down markets.

#### Requests for Information

Requests for information about SDRS may be directed to the South Dakota Retirement System at P.O. Box 1098, Pierre, SD 57501. You may also contact SDRS online at [www.sdrs.sd.gov](http://www.sdrs.sd.gov).

## SOUTH DAKOTA RETIREMENT SYSTEM

### Statement of Fiduciary Net Position

June 30, 2016

Assets	
Cash and cash equivalents	\$ 6,915,822
Receivables	
Employer	2,485,101
Employee	2,642,853
Benefits	35,208
Unsettled investment sales	19,611,040
Accrued interest and dividends	31,516,906
Total receivables	56,291,108
Investments, at fair value	
Fixed income	3,248,164,814
Equities	5,311,369,234
Real estate	1,225,616,938
Private equity	709,610,272
Total investments, at fair value	10,494,761,258
Property, at cost (net of accumulated depreciation of \$13,728)	8,202
Computer software development in progress	1,779,220
Other assets	14,481
Total assets	10,559,770,091
Liabilities	
Accounts payable and accrued expenses	2,123,716
Unsettled investment purchases	26,685,838
Due to brokers – futures transactions	17,498,410
Total liabilities	46,307,964
Net position restricted for pension benefits	\$ 10,513,462,127

See accompanying notes to financial statements.



# **SOUTH DAKOTA RETIREMENT SYSTEM**

## **Statement of Changes in Fiduciary Net Position**

**Year Ended June 30, 2016**

Additions	
Contributions	
Employee	\$ 114,443,295
Employer	<u>114,090,075</u>
Total contributions	<u>228,533,370</u>
Investment Income (Loss)	
From investing activities	
Net depreciation in fair value of investments	(209,983,510)
Interest	108,298,330
Dividends	100,482,773
Real estate	<u>54,191,535</u>
Investment activity income	52,989,128
Less investment activity expenses	<u>(32,818,365)</u>
Net investment activity income	<u>20,170,763</u>
From security lending activities	
Security lending income	3,510,674
Security lending expenses	<u>(845,172)</u>
	<u>2,665,502</u>
Total additions	<u>251,369,635</u>
Deductions	
Benefits	487,053,001
Refunds of contributions	23,443,481
Administrative expenses	<u>3,944,641</u>
Total deductions	<u>514,441,123</u>
Net change in net position	(263,071,488)
Net position restricted for pension benefits:	
Beginning of year	<u>10,776,533,615</u>
End of year	<u><u>\$ 10,513,462,127</u></u>

See accompanying notes to financial statements.

# **SOUTH DAKOTA RETIREMENT SYSTEM**

## **Notes to Financial Statements**

June 30, 2016

### **(1) General Description of the System**

The South Dakota Retirement System (SDRS or the System) is a cost-sharing, multiple-employer public employee retirement system (PERS) established to provide retirement benefits for employees of the state of South Dakota (the State) and its political subdivisions. Members of SDRS include full-time employees of public schools, the State, the Board of Regents, city and county governments, and other public entities. Public schools, cities, and counties may choose not to include certain full-time employees in the System.

SDRS is considered a part of the State financial reporting entity and is included in the State's financial report as a pension trust fund. Authority for establishing, administering, and amending plan provisions is found in South Dakota Codified Law (SDCL) 3-12.

The South Dakota Retirement System Board of Trustees (the Board) is the governing authority of SDRS. The Board consists of 14 elected representatives from participating groups, two appointees of the governor, and an ex-officio nonvoting representative of the South Dakota Investment Council. The elected representatives of the Board are two teacher members; two State employee members; a participating municipality member; a participating county member; a participating classified employee member; a current contributing Class B member other than a justice, judge, or magistrate judge; a county commissioner of a participating county; a school district board member, a justice, judge, or magistrate judge, an elected municipal official of a participating municipality; a retiree; and a faculty or administrative member employed by the Board of Regents. The two Governor's appointees consist of one head of a principal department established pursuant to SDCL 1-32-2, or one head of a bureau under the office of executive management and one individual from the private or public sector.

SDRS is a hybrid defined benefit plan designed with several defined contribution plan type provisions. The system includes three classes of members: Class A-general members, Class B-public safety and judicial members, and Class C Cement Plant Retirement Fund members. Members and their employers make matching contributions, which are defined in State statute. SDRS may expend up to 3% of the annual contributions for administrative expenses subject to approval by the executive and legislative branches of the State.

SDRS provides retirement, disability, and survivor benefits. The right to receive retirement benefits vests after three years of contributory service. Class A members and Class B judicial members who retire after age 65 with three years of service are entitled to an unreduced annual retirement benefit. An unreduced annual retirement benefit is also available after age 55 for Class A members where the sum of age and credited service is equal to or greater than 85 or after age 55 for Class B judicial members where the sum of age and credited service is equal to or greater than 80. Class B public safety members can retire with an unreduced annual retirement benefit after age 55 with three years of contributory service. An unreduced annual retirement benefit is also available after age 45 for Class B public safety members where the sum of age and credited service is equal to or greater than 75. All retirement benefits that do not meet the above criteria may be payable at a reduced level. Class C Cement Plant Retirement Fund members have a normal retirement age of 65 and early retirement is age 55 with the required credited service. Class C Cement Plant provides for disability payments for those disabled on or before March 16, 2001. All participants of the Plan on March 15, 2001 were 100% vested.

## SOUTH DAKOTA RETIREMENT SYSTEM

### Notes to Financial Statements

June 30, 2016

The annual increase in the amount of the SDRS benefits payable on each July 1st is indexed to the consumer price index (CPI) and based on SDRS funded status:

- If the SDRS market value funded ratio is 100% or more – 3.1% COLA
- If the SDRS market value funded ratio is 80.0% to 99.9%, index with the CPI
  - \* 90.0% to 99.9% funded – 2.1% minimum and 2.8% maximum COLA
  - \* 80.0% to 90.0% funded – 2.1% minimum and 2.4% maximum COLA
- If the SDRS market value funded ratio is less than 80% – 2.1% COLA

All benefits except those depending on the Member's Accumulated Contributions are annually increased by the Cost-of-Living Adjustment.

SDRS is a qualified defined benefit retirement plan under Section 401(a) of the Internal Revenue Code and is exempt from federal income taxes. SDRS last received a favorable determination letter dated July 3, 2012, in which the Internal Revenue Service stated that the System, as then designated, was in compliance with the applicable requirements of the Internal Revenue Code. SDRS believes that the system currently is designed and being operated in compliance with the applicable requirements of the Internal Revenue Code, and therefore, SDRS continues to be tax-exempt as of June 30, 2016. Therefore, no provision for income taxes has been included in SDRS's financial statements.

SDRS is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. SDRS participates in the various programs administered by the State. These risk management programs are funded through assessments charged to participating entities. The risk management programs include (1) coverage for risks associated with automobile liability and general tort liability (including public officials' errors and omissions liability, medical malpractice liability, law enforcement liability, and products liability) through the State's Public Entity Pool for Liability Fund, (2) coverage of employee medical claims through the State's health insurance program, (3) coverage for unemployment benefits through the State's Unemployment Insurance Fund, and (4) coverage for workers' compensation benefits through the State's Workers' Compensation Fund. Financial information relative to the self-insurance funds administered by the State is presented in the State of South Dakota Comprehensive Annual Financial Report.

As of June 30, 2016, the number of participating governmental employers is as follows:

School districts	165
State of South Dakota	1
Board of Regents	1
Municipalities	158
Counties	64
Board and Commissions	96
	<hr/>
Total employers	485
	<hr/>

## SOUTH DAKOTA RETIREMENT SYSTEM

### Notes to Financial Statements

June 30, 2016

At June 30, 2016, SDRS membership consists of the following:

Retirees and beneficiaries currently receiving benefits:	
Class A (general employees)	24,722
Class B (public safety and judicial employees)	1,590
Class C (cement plant employees)	242
Total retirees and beneficiaries	<u>26,554</u>
Terminated members entitled to benefits but not yet receiving them:	
Class A (general employees)	16,663
Class B (public safety and judicial employees)	847
Class C (cement plant employees)	44
Total terminated members	<u>17,554</u>
Current active members:	
Vested:	
Class A (general employees)	28,461
Class B (public safety and judicial employees)	2,187
Class C (cement plant employees)	17
Nonvested:	
Class A (general employees)	8,523
Class B (public safety and judicial employees)	752
Total current active members	<u>39,940</u>
Grand total	<u><u>84,048</u></u>

\* There are 123 class A and 11 class B public safety and judicial members or beneficiaries whose benefits are currently suspended but are entitled to future benefits. These members or beneficiaries are included as retirees and beneficiaries in their respective classes as listed.

## (2) Summary of Significant Accounting Policies

### (a) Basis of Accounting and Presentation

The accompanying financial statements are prepared using the accrual basis of accounting in accordance with U.S. generally accepted accounting principles applicable to governmental accounting for a pension trust fund. Employee and employer contributions are recognized when due pursuant to formal commitment, as well as statutory requirements. Pension benefit payments are due the first day of the month following the retirement of a member, and the first of each month thereafter. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Notes to Financial Statements**

June 30, 2016

**(b) *Method Used to Value Investments***

Investments are reported at fair value, in accordance with GASB Statement No. 72. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GASB 72 sets forth the framework for measuring value. The framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels. The three levels of the fair value hierarchy under GASB 72 are described as follows:

Level 1 – Valuation inputs are quoted prices in active markets for identical asset or liability as of the measurement date.

Level 2 – Valuation inputs other than quoted prices included within Level 1 that are observable for an asset or liability, either directly or indirectly.

Level 3 – Valuation inputs are based on significant unobservable inputs for an asset or liability.

As a practical expedient, GASB 72 allows the net asset value (NAV) or its equivalent to be used when a readily determinable fair value is not available. The NAV valuations are based on valuations of the underlying companies as determined and reported by the fund manager or general partner and are excluded from the fair value hierarchy.

Additional required disclosures can be found in Note 5: Cash and Investments.

Investments denominated in foreign currencies are translated into USD using the year-end spot foreign currency exchange rates. Foreign exchange rate gains and losses are included with the net appreciation in fair value of investments.

Alternative investments consist of investments in a variety of markets and industries through partnerships, corporate entities, co-investments, and other investment vehicles. For alternative investments where no readily ascertainable market value exists, management, in consultation with their investment advisors, values these investments in good faith based upon the investment's current financial statements or other information provided by the underlying investment advisor. For all of these alternative investments, SDRS has determined that net asset value reported by the underlying fund approximates the fair value of the investment. These fair value estimates are, by their nature, subjective and based on judgment. These alternative investments were valued at \$2,612,356,121 (24.85% of net position) at June 30, 2016. The estimated fair value of these investments may differ significantly from values that would have been used had a ready market existed.

Foreign exchange rate gains and losses are included with the net appreciation in fair value in investments. Futures contracts are marked to market based on quoted futures prices with changes in fair value reflected in the current period.

Interest is accrued in the period in which it is earned and dividend income is recorded on the ex-dividend date.

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Notes to Financial Statements**

June 30, 2016

**(c) Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the plan administrator to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and changes therein. Actual results could differ from those estimates.

**(d) New GAAP Implementation**

In fiscal year 2016, SDRS implemented Government Accounting Standards Board Statement No. 72, Fair Value Measurement and Application. GASB 72 addresses accounting and financial reporting issues related to fair value measurements and guidance for financial reporting purposes. There was no material impact on valuation inputs used to measure fair value as a result of the implementation of GASB 72.

**(3) Contributions and Reserves**

**(a) Contributions**

Covered employees are required by statute to contribute a percentage of their salary to SDRS as follows:

Class A members	6.0% of salary
Class B public safety members	8.0% of salary
Class B judicial members	9.0% of salary

All participating employers are required to contribute an amount equal to the members' contributions. Members may make an additional contribution of 1.5% of compensation for optional spouse coverage (closed to new enrollees after July 1, 2010).

SDRS is funded by fixed member and employer contributions at a rate established by South Dakota law. On an annual basis, an independent actuarial valuation of SDRS is performed to determine the adequacy of the fixed contributions to pay the normal costs and expenses if the System is fully funded or pay the normal costs, expenses and amortize the unfunded actuarial accrued liability (UAAL) if the System is not fully funded. The June 30, 2016 actuarial valuation of the plan determined that the System is fully funded and that the statutorily required employer contributions meet the requirements for the annual required contributions of the employers under Governmental Accounting Standards Board (GASB) Statement No. 25, *Financial reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans along with amendments included in Statement No. 67, Financial Reporting for Pension Plans*; and the statutorily required employer contributions are sufficient to pay the employer normal cost and expenses. Annual required contributions of the employers equal to the statutorily required contributions have been listed below pursuant to GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers, with revisions in Statement No. 68, Accounting and Financial Reporting for Pensions*.



# SOUTH DAKOTA RETIREMENT SYSTEM

## Notes to Financial Statements

June 30, 2016

Contributions during fiscal year 2016 totaling \$228,533,370 (\$114,443,295 employee, \$114,090,075 employer) were made in accordance with statutory rates. The employee contributions exceed the employer contributions because of optional spouse coverage contributions and employee service purchase payments. Contributions for the last 5 fiscal years are as follows:

	<u>Employer</u>	<u>Percentage contributed</u>
Year ending June 30:		
2016	\$ 114,090,075	100%
2015	109,549,977	100
2014	104,952,985	100
2013	100,376,481	100
2012	98,866,649	100

SDRS allows participating entities to pay their deferred contributions for funding of accrued benefits over periods of up to 20 years and members to pay for the purchase of certain prior service over periods of up to 10 years. Interest is charged at rates of 5% to 8%.

Future payments will be received as follows:

	<u>Employees</u>
Year ending June 30:	
2017	\$ 53,773
2018	32,254
2019	24,389
2020	25,180
2021	22,067
Later	<u>35,756</u>
Deferred contributions receivable at June 30, 2016	<u>\$ 193,419</u>

**(b) Reserves**

The reserve for funding of long-term benefit goals is designed to fund benefit improvements and provide the plan with protection against adverse experience. The reserve for funding of long-term benefit goals is equal to the cumulative amounts credited or debited annually based on the immediate recognition of actuarial investment losses, the five-year recognition of actuarial investment gains and the five-year recognition of SDRS liability gains or losses, less reductions described below. If benefit improvements are enacted into law and funded from the reserve for funding of long-term benefit goals, the reserve for funding of long-term benefit goals is reduced by the present value of all benefits for those improvements. The reserve for funding of long-term benefit goals may also be reduced to offset unfavorable experience or to meet the funding objectives of SDRS as established by the Board of Trustees. As of June 30, 2016, the balance in the reserve for funding of long-term benefit goals is (\$486,167,795). The reserve will increased by net gains of \$909 million that will be recognized in the reserve for funding of long-term benefit goals over the next four years.

## SOUTH DAKOTA RETIREMENT SYSTEM

### Notes to Financial Statements

June 30, 2016

#### (4) Net Pension Liability of the System

The components of the net pension liability of the System at June 30, 2016 was as follows:

Total pension liability	\$10,851,252,302
Plan fiduciary net position	<u>(10,513,462,127)</u>
Net pension liability	<u>\$ 337,790,175</u>

Fiduciary net position as a percentage of net pension liability	96.9%
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**Actuarial Assumptions** – The total pension liability was determined by an actuarial valuation as of June 30, 2016, using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.25%
Salary increases	5.83% at entry to 3.87% after 30 years of service
Discount Rate	7.25% through 2017 and 7.50% thereafter, net of pension plan investment expense

Mortality rates were based on the RP-2000 Employee Mortality Table for males and females, as appropriate.

The actuarial assumptions used in the June 30, 2016 valuation were based on the results of an actuarial experience study for the period of July 1 2005 to June 30, 2011. The mortality assumptions were revised based on an extension of the experience study including mortality experience through June 30, 2013.

**Discount rate** – The discount rate used to measure the total pension liability was 7.25% through 2017 and 7.50% thereafter. The projection of cash flows used to determine the discount rate assumed that plan member contributions will be made at the current contribution rate and that matching employer contributions will be made at rates equal to the member rate. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

**Sensitivity of (asset)/liability to changes in the discount rate** – The following presents the net pension (asset)/liability of the System, calculated using the discount rate of 7.25% through 2017 and 7.50% thereafter, as well as what the System's net pension asset would be if it were calculated using a discount rate that is 1% point lower (6.25/6.50%) or 1% point higher (8.25/8.50%) than the current rate:

	<u>1% Decrease</u>	<u>Current Discount</u> <u>Rate</u>	<u>1% Increase</u>
System's net pension (asset)/liability	\$ 1,890,269,326	\$ 337,790,175	\$ (928,423,300)

## SOUTH DAKOTA RETIREMENT SYSTEM

### Notes to Financial Statements

June 30, 2016

#### (5) Cash and Investments

##### *Cash and Deposits*

Cash and cash equivalents are held by the State Treasurer and were invested in the State's pooled investment fund. Investments in the State's pooled investment fund consist primarily of short-term U.S. Treasury and Agency obligations, short-term U.S. Corporate securities, bank certificates of deposit, and money market funds.

The custodial credit risk for deposits is the risk that, in the event of the failure of a depository institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are held in the possession of an outside party. SDRS has a formal deposit policy specific to custodial credit risk and foreign currencies. Policy states that the USD equivalent of any non-USD currency cannot exceed 2.0% of any portfolio on a trade date +7 days basis. All portfolios as of June 30, 2016 meet policy guidelines. These deposits are not collateralized or covered by depository insurance. As a result, \$3,173,427 was exposed to custodial credit risk, which is recorded in investments in the statement of fiduciary net position.

##### *Investments*

Investment portfolio management is the statutory responsibility of the South Dakota Investment Council (SDIC), which may utilize the services of external money managers for management of a portion of the portfolio. SDIC is governed by the Prudent Man Rule (i.e., the council should use the same degree of care as a prudent man). Current SDIC investment policies dictate limits on the percentage of assets invested in various types of vehicles (equities, fixed income securities, real estate, cash, private equity, etc.). The long-term expected rate of return on pension plan investments was determined using a method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighing the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best estimates of real rates of return for each major asset class included in the pension plan's target asset allocation as of June 30, 2016 (see the discussion of the pension plan's investment policy) are summarized in the following table:

<u>Asset Class</u>	<u>Target Allocation</u>	<u>Long-Term Expected Real Rate of Return</u>
Global Equity	58%	4.8%
Fixed Income	30%	1.8%
Real Estate	10%	4.6%
Cash	<u>2%</u>	0.7%
	100%	

# SOUTH DAKOTA RETIREMENT SYSTEM

## Notes to Financial Statements

June 30, 2016

Below is a detail of the investment balances and amounts managed by the respective fund managers:

	<u>Cost</u>	<u>Fair value</u>
State of South Dakota Investment Council	\$ 6,787,130,150	\$ 7,611,316,131
Apollo	8,767,102	5,595,961
Blackstone Credit Liquidity	1,539,353	80,159
Blackstone Private Equity	124,005,272	185,137,531
Blackstone Real Estate Partners	598,470,803	794,750,606
Brandes Global Mid-Cap	61,844,637	58,140,551
Bridgewater Pure Alpha Fund II	36,742,005	73,490,885
Capital International	39,785,052	32,367,908
Cargill North American Real Estate Partners	11,269,024	10,754,569
Carlyle	65,803,528	80,613,111
CINVIN	95,603,531	68,878,864
Crossroads Investment Advisors LP	1,219,686	1,065,438
CVC	46,886,184	45,482,367
CVI Global Value Fund	56,815,984	33,721,114
Cypress Merchant Banking Partners LP	170,972	170,972
Dimensional Fund Advisors, Inc.	8,977,461	49,312,252
Doughty Hanson & Co European Real Estate	9,333,729	5,058,183
Doughty Hanson PE IV	32,901,529	27,212,225
Elevation Partners	1,013,769	822,130
KKR Associates	8,814,039	11,314,081
Lone Star Real Estate	195,173,811	203,453,076
Pinebridge	5,910,842	3,102,290
Riverstone	82,228,117	76,093,482
Rockport RE IV	50,383,060	61,971,165
Sanders All Asset Value	21,397,766	23,886,798
Sanders Capital	40,790,550	40,362,590
Silver Lake Partners LP	123,267,871	177,349,872
Starwood RE IX	114,931,879	144,033,378
TCW Opp MBS Strategy	618,590,813	669,223,569
	<hr/>	<hr/>
Total	\$ 9,249,768,519	\$ 10,494,761,258
	<hr/>	<hr/>

# SOUTH DAKOTA RETIREMENT SYSTEM

## Notes to Financial Statements

June 30, 2016

**(a) Interest Rate Risk**

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The investment grade fixed income portfolios of SDRS are benchmarked to the duration of the Citigroup Broad Investment Grade (BIG) Index and must fall between 70% and 130% of the BIGs duration.

The durations of the various investment types are listed in the following table:

	<u>Fair value</u>	<u>Duration (in years)</u>
Investment type:		
U.S. Treasuries	\$ 77,937,480	5.80
U.S. Treasury Bills	88,393,401	0.21
U.S. Treasury strips	152,998,425	8.76
U.S. agencies	54,032,141	3.80
U.S. agencies discount notes	31,151,461	0.08
Investment grade corporates	388,068,688	4.78
High-yield corporates	758,588,244	3.83
Agency mortgage-backed securities	353,424,782	3.75
Non-agency mortgage-backed securities	610,162,086	0.54
Total	<u>\$2,514,756,708</u>	3.36

The SDRS fixed income portfolios invest in mortgage-backed securities. These securities are sensitive to prepayments by mortgagees, which is likely in declining interest rate environments, thereby reducing the value of these securities.

**(b) Credit Risk**

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to SDRS. SDIC sets the investment policy annually for the SDRS. This policy establishes the average percentage invested in each asset category and the fund allocation range that each asset category can vary during the fiscal year. As of June 30, 2016, the portfolios held the following investments, excluding those issued by or explicitly guaranteed by the U.S. government, which are not considered to have credit risk. The investments are grouped as rated by Moody's Investors Service.

# **SOUTH DAKOTA RETIREMENT SYSTEM**

## **Notes to Financial Statements**

June 30, 2016

	<u><b>Fair value</b></u>
Moody's rating:	
Aaa	\$ 981,564,975
Aa	91,160,699
A	145,800,096
Baa	215,772,906
Ba	224,724,831
B	251,404,755
Caa	471,210,615
Ca	175,793,150
P-1	31,151,462
Unrated	164,220,031
Total	<u><u>\$ 2,752,803,520</u></u>

**(c) Concentration of Credit Risk**

Concentration of credit risk is the risk of loss that may be attributed to the magnitude of SDRS's investment in a single issuer. SDRS does not have guidelines to limit its investments in any particular investment. SDRS does not have investments in any one issuer that represent 5% or more of the total fair value of investments as of June 30, 2016 (excluding those issued by or explicitly guaranteed by the U.S. government).



# SOUTH DAKOTA RETIREMENT SYSTEM

## Notes to Financial Statements

June 30, 2016

**(d) Foreign Currency Risk**

Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. SDRS's exposure to foreign currency risk derives from its positions in foreign currency and foreign-currency-denominated equity and fixed income investments. SDRS does not hedge foreign currency back to U.S. dollars (to match the unhedged benchmark), but does allow hedging under certain circumstances, when deemed appropriate. The portfolio's exposure to foreign currency risk at June 30, 2016 is as follows (in U.S. dollar fair value):

	<u>Equities</u>	<u>Fixed income</u>	<u>Cash</u>	<u>Total</u>
Currency:				
Australian Dollar	\$ 7,176,790	\$ -	\$ 42,353	\$ 7,219,143
Brazilian Real	2,525,783	-	53,246	2,579,029
British Pound	251,113,815	-	1,527,492	252,641,307
Canadian Dollar	83,589,193	-	211,590	83,800,783
Danish Kroner	3,145,592	-	44,618	3,190,210
Euro	234,706,732	-	356,210	235,062,942
Hong Kong Dollar	4,362,427	-	27,170	4,389,597
Hungarian Forint	569,869	-	19,166	589,035
Japanese Yen	110,498,801	-	888,641	111,387,442
Korean Won	56,284,913	-	2,936	56,287,849
Norwegian Krone	600,195	-	-	600,195
Singapore Dollar	391,420	-	-	391,420
Swedish Krona	1,132,909	-	-	1,132,909
Swiss Franc	217,355,158	-	4	217,355,162
Thai Baht	920,319	-	-	920,319
Total fair value	<u>\$ 974,373,916</u>	<u>\$ -</u>	<u>\$ 3,173,426</u>	<u>\$ 977,547,342</u>

Investments with limited partnerships and certain global equity investments with external managers, which are not included in the table above, may expose SDRS's portfolio to additional foreign currency risk. The total fair value of investments in real estate and private equity limited partnerships as of June 30, 2016 was \$1,935,227,210. The total fair value of global equity and high-yield fixed income investments managed by external managers was \$146,689,934 and \$33,801,273, respectively.

**(e) Return on Investments**

During fiscal year 2016, SDRS's investments (including investments bought and sold, as well as held during the year) depreciated in value by \$209,983,510.

The calculation of realized gains and losses is independent of a calculation of the net change in the fair value of investments. Realized gains and losses on investments that had been held in more than one fiscal year and sold in the current year were included as a change in the fair value of investments reported in the prior years and current year.

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Notes to Financial Statements**

June 30, 2016

#### **Change in Fair Value of Investments**

Appreciation (Depreciation) in fair value of investments:

Equities	\$ (545,219,691)
Fixed income	39,076,076
Real estate	(86,793,174)
Private equity	(106,178,621)
Change in accrued income	8,235,164

Total decrease in fair value	<u>(690,880,246)</u>
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Realized gain (loss) on investments:

Equities	260,800,394
Fixed income	65,731,698
Real estate	78,263,535
Private equity	<u>124,615,366</u>

Total net realized gains	<u>529,410,993</u>
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Futures - change in unrealized gain (loss)	(20,110,920)
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Futures - Realized gain (loss)	<u>(28,403,337)</u>
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Net loss on futures	<u>(48,514,257)</u>
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Net depreciation in investments	<u>\$ (209,983,510)</u>
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#### **(f) Securities Lending**

State statutes and the SDRS policies permit the use of investments for securities lending transactions. These transactions involve the lending of corporate debt, foreign equity securities, and domestic equity securities to broker-dealers for collateral in the form of securities, with the simultaneous agreement to return the collateral for the same securities in the future. The SDRS's securities custodian is an agent in lending securities and shall accept only U.S. government securities or its agencies as collateral for any loan or loaned securities. The collateral required must equal 102% of fair value plus accrued interest for corporate debt securities, 102% of fair value for U.S. equity securities, and 105% of fair value for foreign securities except in the case of loans of foreign securities, which are denominated and payable in U.S. dollars, in which event the collateral required is 102% of fair value. The earnings generated from the collateral investments result in the gross earnings from lending activities, which is then split on a percentage basis with the lending agent.

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Notes to Financial Statements**

**June 30, 2016**

The fair value of securities on loan as of June 30, 2016 was \$175,272,679 and the collateral held on the same date was \$179,413,589. The SDRS has no credit risk exposure to borrowers because the amounts the SDRS owes the borrowers exceed the amounts the borrowers owe the SDRS. The contract with the lending agent requires the agent to indemnify the SDRS if the borrowers fail to return the loaned securities and the collateral is inadequate to replace the securities lent.

All securities loans can be terminated on demand by either the SDRS or the borrower. SDRS does not have the ability to pledge or sell collateral securities unless the borrower defaults; therefore, no asset and corresponding liability for the collateral value of securities received has been established on the statement of fiduciary net position. Regarding restrictions on loans, the securities lending agreement does limit the total value of securities that can be out on loan on any given day.

**(g) *Custodial Credit Risk***

The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. SDRS securities lending policies are detailed in the preceding Securities Lending section. As of June 30, 2016, the SDRS does not have custodial credit risk with regard to the security lending collateral.

# SOUTH DAKOTA RETIREMENT SYSTEM

## Notes to Financial Statements

June 30, 2016

### *(h) Fair Value Measurements and Applications*

The following table shows the fair value in accordance with the GASB hierarchy:

		Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<b>Investments by fair value level</b>	<b>06/30/16</b>			
Fixed Income securities				
U.S. Treasuries	\$ 77,937,480	\$ -	\$ 77,937,480	\$ -
U.S. Treasury Bills	88,393,401	-	88,393,401	-
U.S. Treasury STRIPS	152,998,425	-	152,998,425	-
U.S. Agencies	54,032,141	-	54,032,141	-
U.S. Agency Discount Notes	31,151,461	-	31,151,461	-
Investment Grade Corporates	388,068,688	-	396,702,202	-
High Yield Corporates	758,588,244	-	749,954,731	-
Agency Mortgage-Backed Securities	353,424,781	-	353,424,781	-
Non-Agency Mortgage-Backed Securities	610,162,086	-	610,162,086	-
Total fixed income securities	2,514,756,708	-	2,514,756,708	-
Equity securities				
Domestic Stock	4,017,313,955	4,016,858,525	455,430	-
Depository Receipts	85,697,094	85,697,094	-	-
ETF - Exchange Traded Funds	117,139,750	117,139,750	-	-
International Stock	974,373,913	974,373,913	-	-
Stock Warrants	7,802,933	7,802,933	-	-
Total equity securities	5,202,327,645	5,201,872,215	455,430	-
Alternative investments				
Real Estate Funds	5,058,183	-	-	5,058,183
Total alternative investments	5,058,183	-	-	5,058,183
<b>Total investments by fair value level</b>	<b>\$ 7,722,142,536</b>	<b>\$ 5,201,872,215</b>	<b>\$ 2,515,212,138</b>	<b>\$ 5,058,183</b>
<b>Investments measured at the net asset value (NAV)</b>				
Short Term Investment Funds	659,552,084			
Emerging Markets Small Cap Equity Mutual Funds	49,312,252			
Multi Strategy Hedge Funds	97,377,683			
Alternative investments				
Real Estate Funds	1,220,558,755			
Private Equity Funds	709,610,272			
Other Funds	33,801,273			
Total alternative investments	1,963,970,301			
<b>Total Investments measured at the NAV</b>	<b>\$ 2,770,212,319</b>			
<b>Total Investments measured at the fair value</b>	<b>\$ 10,492,354,855</b>			
Plus: Cash held by Fund Managers	3,174,787			
Less: G/L on FX Transactions	(611,056)			
Less: Accrued Monthly Interest	(157,328)			
	10,494,761,258			
<b>Investment derivative instruments</b>				
Futures Contracts (liability)	(17,498,410)	(17,498,410)	-	
Foreign Exchange Forward Contracts	(611,056)	-	(611,056)	
<b>Total investment derivative instruments</b>	<b>\$ (18,109,466)</b>	<b>\$ (17,498,410)</b>	<b>\$ (611,056)</b>	

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Notes to Financial Statements**

**June 30, 2016**

Equity securities classified in Level 1 of the fair value hierarchy are valued using quoted prices in active markets for identical securities as of the measurement date as issued by pricing vendors. The security classified in Level 2 of the fair value hierarchy is valued using a quoted price for an identical security in an inactive market.

Fixed income securities classified in Level 2 of the fair value hierarchy are valued using observable inputs other than quoted prices for identical securities. The prices are determined by the use of matrix pricing techniques maintained by the various pricing vendors for these securities. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices.

Real estate funds classified in Level 3 of the fair value hierarchy are real estate alternative investments that invest primarily in overseas commercial real estate. These are investments which quoted prices are not readily available and are valued at estimated values as determined by the General Partner (GP). Investments are valued by the GP using one or more valuation methodologies with reference to the International Private Equity and Venture Capital Valuation Guidelines. The estimated fair values are subjective and based on judgment.

The Other Fund classified in Level 3 of the fair value hierarchy is valued at zero. It is an investment in an alternative investment fund that invested in distressed and defaulted debt securities and equities of financially troubled companies. All positions in the fund have been liquidated and only cash remains. The fund holds contingent liabilities that offset cash. Due to the highly questionable outcome of the contingent liabilities it has been determined that a value of zero best reflects the fair value considering the information available as of June 30, 2016.

SDRS holds shares or interest in investments where the fair value of the investments are measured on a recurring basis using net asset value per share (or its equivalent) of the investment as a practical expedient. The NAV valuations are based on valuations of the underlying companies as determined and reported by the fund manager or general partner.

Derivative instruments classified in Level 1 of the fair value hierarchy represents the pending variance margin on futures contracts which is calculated using quoted prices in active markets for identical securities. Derivative instruments classified in Level 2 of the fair value hierarchy are valued using observable inputs other than quoted prices for identical securities. The foreign currency forward contract valuations are determined by interpolating FX rates for various settlement dates as of June 30, 2016.

# SOUTH DAKOTA RETIREMENT SYSTEM

## Notes to Financial Statements

June 30, 2016

The valuation method for investments measured at the net asset value (NAV) per share (or its equivalent) is presented in the following table:

### Investments Measured at the NAV

	<u>Fair Value</u>	<u>Unfunded Commitments</u>	<u>Redemption Frequency (if currently eligible)</u>	<u>Redemption Notice Period</u>
Short-Term Investment Funds (a)	\$ 659,552,084		Daily	0 days
Emerging Markets Small Cap Equity Mutual Funds (b)	49,312,252		Daily	1 day
Multi Strategy Hedge Funds (c)	97,377,683		Monthly	5 -30 days
Alternative investments				
Real Estate Funds (d)	1,220,558,755	\$ 667,369,243		
Private Equity Funds (e)	709,610,272	575,174,180		
Other Funds (f)	33,801,273			
Total alternative investments	<u>1,963,970,301</u>			
Investments measured at the net asset value (NAV)	\$ 2,770,212,319			
Real Estate Funds (Level 3)	\$ 5,058,183	\$ 13,193,411		

(a) Short-Term Investment Funds. This type includes investments in four open-end mutual funds that invest exclusively or primarily in high-quality, short-term securities that are issued or guaranteed by the U.S. government or by U.S. government agencies and instrumentalities. The fair values of the investments in this type have been determined using the NAV per share of the investments.

(b) Emerging Markets Small Cap Equity Mutual Funds. This type includes one investment in an open-end mutual fund that emphasizes broad diversification and consistent exposure to emerging market small company stocks. The fair value of the investment in this type has been determined using the NAV per share of the investment.

(c) Multi-Strategy Hedge Funds. This type includes two investments in funds that may invest in a wide range of asset classes in order to meet fund objectives. The fair values of the investments in this type have been determined using the NAV per share of the investments.

(d) Real Estate funds. This type includes 23 real estate funds that invest primarily in commercial real estate. The fair values of the investments in this type have been determined using the NAV per share (or its equivalent) of the portfolio's ownership interest in partners' capital. These investments can never be redeemed from the funds. Distributions from each fund will be received as the underlying investments of the funds are liquidated. It is expected that the underlying assets of the funds will be liquidated over the next 20 years. Because it is not probable that any individual investment will be sold, the fair value of each individual investment has been determined using the NAV per share (or its equivalent) of the portfolio's ownership interest in partners' capital.

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Notes to Financial Statements**

June 30, 2016

(e) Private Equity Funds. This type includes 37 private equity funds that invest primarily in leveraged buyouts. The fair values of the investments in this type have been determined using the NAV per share (or its equivalent) of the portfolio's ownership interest in partners' capital. These investments can never be redeemed from the funds. Distributions from each fund will be received as the underlying investments of the funds are liquidated. It is expected that the underlying assets of the funds will be liquidated over the next 20 years. Because it is not probable that any individual investment will be sold, the fair value of each individual investment has been determined using the NAV per share (or its equivalent) of the portfolio's ownership interest in partners' capital.

(f) Other Funds. This type includes two other alternative investments that invest primarily in a broad range of debt, debt-related, and/or real estate-related investments. The fair values of the investment has been determined using the NAV per share (or its equivalent) of the portfolio's ownership interest in partners' capital. This investment can never be redeemed from the funds. Distributions from the fund will be received as the underlying investments of the funds are liquidated. It is expected that the underlying assets of the fund will be liquidated over the next 5 years. Because it is not probable that any individual investment will be sold, the fair value of each individual investment has been determined using the NAV per share (or its equivalent) of the portfolio's ownership interest in partners' capital.

#### **(6) Derivatives**

Derivatives are generally defined as contracts whose values depend on, or derive from, the value of an underlying asset, reference rate, or index. SDRS is exposed to various derivative products through the investment management of the SDIC and its external managers. All of the SDRS's derivatives are classified as investment derivatives.

##### ***Futures Contracts***

A futures contract is a contract to buy or sell units of an index or financial instrument at a specified future date at a price agreed upon when the contract is originated. The South Dakota Investment Council purchases and sells futures contracts as a means of adjusting the SDRS portfolio mix at a lower transaction cost than the transactions, which would otherwise occur in the underlying portfolios. During fiscal year ended June 30, 2016, S&P 500 futures and 10-year U.S. Treasury note futures were utilized. Upon entering into such a contract, the SDRS pledges to the broker cash or U.S. government securities equal to the minimum initial margin requirement of the futures exchange. Additionally, SDRS receives or pays a daily variation margin, which is an amount of cash equal to the daily fluctuation in value of the contract. The pending variation margin at June 30, 2016 of (\$17,498,410) is presented in the statement of fiduciary net position as "Due to Broker – Futures Transactions" The change in fair value of the futures contracts is presented in the statement of changes in fiduciary net position as "Net depreciation in fair value of investments." The net change in fair value from futures contracts for fiscal year ended June 30, 2016 was (\$48,514,258).

# SOUTH DAKOTA RETIREMENT SYSTEM

## Notes to Financial Statements

June 30, 2016

Futures contract positions at June 30, 2016 were as follows:

<u>Description</u>	<u>Expiration date</u>	<u>Open position</u>	<u>Number of contracts</u>	<u>Notional Contract size</u>	<u>Fair value</u>
U.S. Treasury note	September 2016	Long	2,335	100,000 par value 6%, 10-year U.S. Treasury note	\$ 310,518,527
S&P 500 Index	September 2016	Short	14,800		\$ (1,546,748,000)

### *Foreign Currency Forward Contracts*

The SDIC enters into foreign exchange forward contracts for SDRS to manage foreign currency exposure, as permitted by portfolio policies. The fair values of the contracts are presented in the Statement of Fiduciary Net Position as Investments, at fair value – Equities. The change in fair value of the forward contracts is presented in the statement of changes in fiduciary net position as “Net depreciation in fair value of investments.” The net change in fair value from foreign currency forward contracts for fiscal year ended June 30, 2016 was \$1,203,217. At June 30, 2016, the foreign currency forward contracts outstanding were as follows:

<u>Description</u>	<u>Notional amount</u>	<u>Currency</u>	<u>Value date</u>	<u>Fair value (US dollars)</u>
Forward sale	\$ (20,770,519)	CHF	8/10/2016	\$ 211,770
Forward sale	(158,375,000)	CNY	11/30/2016	110,191
Forward purchase	158,375,000	CNY	11/30/2016	(933,016)

### *(a) Credit Risk*

SDRS is exposed to credit risk on derivative instruments that are in asset positions. The SDIC attempts to minimize credit risk by entering into derivatives contracts with major financial institutions. At June 30, 2016, the net fair value of foreign currency forward contracts was \$211,770. This represents the maximum loss that would be recognized at the reporting date if all counterparties failed to perform as contracted. The credit ratings of the counterparties are as follows:

	<u>Number of counterparties</u>	<u>Fair value</u>
Moody's credit rating: A1	1	\$ 211,770

### *(b) Foreign Currency Risk*

SDRS is exposed to foreign currency risk on its foreign currency forward contracts because they are denominated in foreign currencies. The net fair value of the foreign currency forward contracts in U.S. dollars is \$(611,056).



## SOUTH DAKOTA RETIREMENT SYSTEM

### Notes to Financial Statements

June 30, 2016

#### (7) **Compensated Absences**

Annual leave is earned by all SDRS employees. Upon termination, SDRS employees are eligible to receive compensation for their accrued annual leave balances. At June 30, 2016, a liability existed for accumulated annual leave calculated at the employees' June 30, 2016 pay rate in the amount of \$153,003. Employees who have been continuously employed by SDRS and the State for at least seven years prior to the date of their retirement, voluntary resignation, or death will receive payment for one-fourth of their accumulated sick leave balance with such payment not to exceed the sum of 12 weeks of the employee's annual compensation. For employees who have not been employed for seven continuous years, an accrued liability is calculated assuming the likelihood that they will meet the seven-year threshold in the future. At June 30, 2016, a liability existed for accumulated and accrued sick leave calculated at the employees' June 30, 2016 pay rate in the amount of \$169,282.

	<u>2016</u>	<u>2015</u>	<u>Percentage change</u>
Total compensated absences	\$ 322,285	\$ 298,291	8.04%

The total leave liability for the current year is on the statement of fiduciary net position available for benefits in accounts payable and accrued expenses.

#### (8) **Operating Leases**

The SDRS has entered into an agreement to lease office space effective September 2012 and has a term of ten years. A schedule of minimum office rental payments as of June 30, 2016, is as follows for the fiscal year ending June 30:

2017	\$ 104,471
2018	104,471
2019	104,471
2020	104,471
2021	104,471
Thereafter	<u>104,471</u>
Total remaining minimum payments	<u>\$ 626,826</u>

Lease expense for the year ending June 30, 2016 was \$104,471.

#### (9) **Supplemental Retirement Plan**

SDRS offers a deferred compensation plan known as the Supplemental Retirement Plan (SRP), created in accordance with Internal Revenue Code Section 457. SRP is available to all public employees and permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseen emergency.

All amounts of compensation deferred under the SRP, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights are at all times held in trust for the exclusive benefit of the participants until made available to a participant or the participant's beneficiary.

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Notes to Financial Statements**

June 30, 2016

Of the \$288,381,719 net position restricted for plan benefits at June 30, 2016, \$174,975,562 was held in trust for employees of the State, while the remaining \$113,406,157 represents the assets held in trust for employees of other jurisdictions. In order to avoid duplication in reporting, the SDRS total of \$1,681,629 is included in the State total and the State's comprehensive annual financial report for the year ended June 30, 2016.

#### **(10) Special Pay Plan**

The Special Pay Plan (SPP) was established in July 2004 as a qualified plan pursuant to Internal Revenue Code Section 401(a) under the administrative responsibility of the SDRS Board of Trustees. South Dakota state government and the South Dakota Board of Regents are participating units and every state political subdivision may become a participating unit in the plan. The SPP mandates that qualifying employees (over age 55 and \$600 or more in special pay) of participating units defer 100% of their special lump-sum termination pay to the plan. The participating unit transfers the deferred pay to the fund. This deferred pay is available to a participant immediately after termination, upon later retirement, or to beneficiaries or an estate upon the participant's death.

Of the \$46,602,150 net position restricted for plan benefits at June 30, 2016, \$26,011,589 was held in trust for employees of the State, while the remaining \$20,590,561 represents the assets held in trust for employees of other jurisdictions. In order to avoid duplication in reporting, the SDRS total of \$22,563 is included in the State total and the State's comprehensive annual financial report for the year ended June 30, 2016.

#### **(11) Plan Termination**

SDRS is administered in accordance with South Dakota statutes. The statutes provide for full vesting in accrued benefits upon termination of the plan (SDCL 3-12-72.2).

#### **(12) Commitments**

At June 30, 2016, SDRS had uncalled capital commitments to private equity limited partnerships totaling approximately \$684,735,292 and to real estate limited partnerships totaling approximately \$1,095,521,684. The commitments may be called at the discretion of the general partner or may never be called.

#### **(13) Litigation**

Deutsche Bank and Wilmington Trust Company have filed a number of actions around the country against selling shareholders, and those actions are all now consolidated in a Multi District Panel proceeding in the Southern District of New York (In re: Tribune Company Fraudulent Conveyance Litigation, Case No. 11-MD-2296). A separate adversary proceeding which was pending in Delaware has been consolidated into this action as well (The Official Committee of Unsecured Creditors of Tribune Company, on behalf of Tribune Company v. Dennis J. Fitzsimmons, et al., Case No. 1:12-cv-02652). SDRS is a defendant as a result of selling Tribune Stock in connection with a leveraged buyout of the Tribune Company in 2007. Through this lawsuit the creditors of Tribune Company are attempting to claw-back funds received in connection with the sale of the stock, which, in the case of SDRS, is approximately four million dollars. SDRS contends that it has persuasive arguments favoring dismissal and its counsel is vigorously working on this. The pending legal action does not represent an immediate negative contingency.

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Notes to Financial Statements**

June 30, 2016

#### **(14) Assets Used in Plan Operations**

These assets represent computer software development costs used by the System and are recorded at cost. Depreciation and amortization are calculated on the straight-line method over the estimated useful lives of the assets. The estimated useful life of computer software development costs is 10-15 years.

2016

Computer software development in progress	\$1,779,220
---	-------------

In March 2014, development began on the South Dakota Retirement System (RETAPP) system. Costs of the RETAPP system will be capitalized and amortized once the application development phase is completed. The balance on contracts pertaining to the completion of the RETAPP project at June 30, 2016 was \$700,000.



Required Supplementary Information  
June 30, 2016

# South Dakota Retirement System

# SOUTH DAKOTA RETIREMENT SYSTEM

## Schedules of Required Supplementary Information

June 30, 2016

### SCHEDULE OF CHANGES IN THE SYSTEM'S NET PENSION LIABILITY

#### Last Fiscal Year

	2016	2015	2014
<b>Total pension liability</b>			
Service cost	\$ 184,923,317	\$ 179,349,820	\$ 161,697,696
Interest	745,774,586	712,632,857	633,951,211
Changes in benefit terms	-	-	(5,082,771)
Differences between expected and actual experience	78,645,840	55,821,847	78,328,269
Changes of assumptions	-	-	604,281,184
Cement plant consolidation	-	-	60,649,185
Benefit payments, including refunds	(510,496,482)	(482,494,871)	(450,490,712)
<b>Net change in total pension liability</b>	<u>498,847,261</u>	<u>465,309,653</u>	<u>1,083,334,062</u>
<b>Total pension liability - beginning</b>	<u>10,352,405,041</u>	<u>9,887,095,388</u>	<u>8,803,761,326</u>
<b>Total pension liability - ending</b>	<u><u>10,851,252,302</u></u>	<u><u>10,352,405,041</u></u>	<u><u>9,887,095,388</u></u>
<b>Plan fiduciary net position</b>			
Contributions - employer	114,090,075	109,549,977	104,952,985
Contributions - member	114,443,295	110,152,580	106,175,381
Net investment income	22,836,265	435,682,659	1,695,543,796
Benefit payments, including refunds	(510,496,482)	(482,494,871)	(450,490,712)
Administrative expense	(3,944,641)	(3,911,222)	(3,853,073)
Cement plant consolidation	-	-	69,519,407
<b>Net change in plan fiduciary net position</b>	<u>(263,071,488)</u>	<u>168,979,123</u>	<u>1,521,847,784</u>
<b>Plan fiduciary net position - beginning</b>	<u>10,776,533,615</u>	<u>10,607,554,492</u>	<u>9,085,706,708</u>
<b>Plan fiduciary net position - ending</b>	<u><u>\$ 10,513,462,127</u></u>	<u><u>\$ 10,776,533,615</u></u>	<u><u>\$ 10,607,554,492</u></u>
<b>System's net pension liability(asset) - ending</b>	<u><u>\$ 337,790,175</u></u>	<u><u>\$ (424,128,574)</u></u>	<u><u>\$ (720,459,104)</u></u>

This schedule is presented to illustrate the requirement to show information for 10 years. However, until a full 10-year trend is compiled, pension plans should present information for those years in which information is available.

See Notes to Required Supplementary Information

**SOUTH DAKOTA RETIREMENT SYSTEM**  
**Schedules of Required Supplementary Information**

June 30, 2016

**SCHEDULE OF SYSTEM'S NET PENSION LIABILITY (ASSET)**

**Last Fiscal Year**

	2016	2015	2014
Total pension liability	\$ 10,851,252,302	\$ 10,352,405,041	\$ 9,887,095,388
Plan fiduciary net position	10,513,462,127	10,776,533,615	10,607,554,492
System's net pension liability (asset)	<u>\$ 337,790,175</u>	<u>\$ (424,128,574)</u>	<u>\$ (720,459,104)</u>
Plan fiduciary net position as a percentage of the total pension liability	96.89%	104.10%	107.29%
Actuarial projected covered-employee payroll	1,829,641,009	1,758,315,755	1,685,627,785
System's net pension liability (asset) as a percentage of covered-employee payroll	18.462%	-24.121%	-42.741%

This schedule is presented to illustrate the requirement to show information for 10 years. However, until a full 10-year trend is compiled, pension plans should present information for those years in which information is available.

**SCHEDULE OF SYSTEM'S CONTRIBUTIONS**

**Last Fiscal Year**

	2016	2015	2014
Actuarially determined contribution	\$ 82,747,112	\$ 190,091,516	\$ 172,001,459
Contributions in relation to the actuarially determined contribution	114,090,075	109,549,977	104,923,505
Contribution deficiency (excess)	<u>\$ (31,342,963)</u>	<u>\$ 80,541,539</u>	<u>\$ 67,077,954</u>
Reported covered-employee payroll	1,829,641,099	1,758,315,755	1,685,627,785
Contributions as a percentage of covered-employee payroll	6.236%	6.230%	6.225%

This schedule is presented to illustrate the requirement to show information for 10 years. However, until a full 10-year trend is compiled, pension plans should present information for those years in which information is available.

See Notes to Required Supplementary Information

SOUTH DAKOTA RETIREMENT SYSTEM  
Schedules of Required Supplementary Information

June 30, 2016

**SCHEDULE OF INVESTMENT RETURNS**

**Last Fiscal Year**

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
Annual money-weighted rate or return, net of investment expenses	0.21%	4.17%	18.91%	19.01%	1.37%	25.27%	18.20%	-21.05%	-8.93%	21.07%
Annual time-weighted rate or return, net of investment expenses	0.30%	4.18%	18.90%	19.02%	1.45%	25.18%	17.99%	-20.89%	-9.00%	21.06%

See Notes to Required Supplementary Information

## SOUTH DAKOTA RETIREMENT SYSTEM

### Notes to Schedule of Required Supplementary Information

June 30, 2016

*Methods and assumptions used in calculations of actuarially determined contributions.* The actuarially determined contribution rates in the schedule of System's contributions are calculated as of July 1, two years prior to the end of the fiscal year in which contributions are reported. The following actuarial methods and assumptions were used to determine contribution rates reported in that schedule:

Valuation date	June 30, 2016
Actuarial cost method	Entry age normal
Authorization method	Level percentage of pay
Remaining amortization period	0 Years
Asset valuation method	The prior year's Actuarial Value of Assets is credited each year with the assumed rate of investment return plus non-investment cash flow and SDRS liability gains or losses for the year, constrained to a range of 80% to 120% of the Fair Value of Assets
Actuarial assumptions:	
Investment rate of return	7.25% through FY 2017 and 7.5% thereafter
Projected salary increases	5.83% at entry to 3.75% after 30 years of service
Post-retirement mortality table:	
Active Members	RP-2000 Employee Mortality Table projected generationally with Scale BB, with males adjusted by 85% and females by 48%.
Healthy inactive members, retired members and beneficiaries:	RP-2000 Combined Healthy Mortality Table projected generationally with Scale BB, with males adjusted by 91% and females by 90%.
Disabled inactive and retired members:	RP-2000 Disabled Retiree Mortality Table projected generationally with Scale BB.





Other Supplementary Information  
June 30, 2016

## South Dakota Retirement System

## **SOUTH DAKOTA RETIREMENT SYSTEM**

### **Other Supplementary Information**

**Year Ended June 30, 2016**

#### **Schedule of Administrative Expenses**

Personal services:	
Salary and per diem	\$ 1,868,874
Employee benefits	<u>456,432</u>
Total personal services	<u>2,325,306</u>
Operating expenses:	
Travel	<u>93,593</u>
Contractual services:	
Audit	127,150
Finance	6,435
Valuations	15,000
Consulting	4,951
Studies	26,571
Special studies	83,443
Legal	37,867
Communications	45,000
Medical	6,588
Operations	<u>696,702</u>
Total contractual services	<u>1,049,707</u>
Supplies and materials	284,300
Capital assets	<u>191,735</u>
Total operating expenses	<u>1,619,335</u>
Total administrative expenses	<u><u>\$ 3,944,641</u></u>

# **SOUTH DAKOTA RETIREMENT SYSTEM**

## **Other Supplementary Information**

Year Ended June 30, 2016

### **Schedule of Investment Activity Expenses**

#### **Investment managers**

State of South Dakota Investment Council	\$ 9,108,401
Blackstone Private Equity	(801,609)
Blackstone Real Estate Partners	(3,008,589)
Brandes Global Mid-Cap	520,129
Capital International	882,794
Cargill North American Real Estate Partners	55,588
Carlyle	2,178,699
CINVIN	981,964
Crossroads Investment Advisors LP	49,211
CVC	153,120
CVI	509,131
Dimensional Fund Advisors, Inc.	212,320
DLJ Merchant Banking Partners LP	14
Doughty Hanson & Co European Real Estate	441,405
Doughty Hanson PE IV	93,900
Elevation Partners	25,058
KKR Associates	(14,406)
Lone Star Real Estate	6,269,693
Riverstone	4,341,849
Rockpoint Real Estate	2,802,399
Sanders All Asset Value	290,889
Sanders Capital	264,132
Silver Lake Partners LP	2,676,822
Starwood Real Estate	1,650,252
TCW Opp MBS Strategy	<u>3,135,199</u>

Total investment activity expenses	<u><u>\$ 32,818,365</u></u>
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CPAs & BUSINESS ADVISORS

**Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards**

To the Board of Trustees  
South Dakota Retirement System  
Pierre, South Dakota

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the South Dakota Retirement System (SDRS), as of and for the year ended June 30, 2016, and the related notes to the financial statements, and have issued our report thereon dated October 19, 2016.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered SDRS's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of SDRS's internal control. Accordingly, we do not express an opinion on the effectiveness of the SDRS's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether SDRS's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

**Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

A handwritten signature in black ink that reads "Eide Bailly LLP". The signature is written in a cursive, flowing style.

Boise, Idaho  
October 19, 2016



Financial Statements  
June 30, 2016

# South Dakota Retirement System Supplemental Retirement Plan





CPAs & BUSINESS ADVISORS

## Independent Auditor's Report

To the Board of Trustees  
South Dakota Retirement System  
Pierre, South Dakota

### Report on the Financial Statements

We have audited the accompanying financial statements of the South Dakota Retirement System Supplemental Retirement Plan (the Plan), which comprise the statement of fiduciary net position as of June 30, 2016, and the related statement of changes in fiduciary net position, for the year then ended, and the related notes to the financial statements.

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective statement of fiduciary net position of the South Dakota Retirement System Supplemental Retirement Plan, as of June 30, 2016, and the respective statement of changes in fiduciary net position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

**Other Matters****Required Supplementary Information**

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 42-45 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated October 19, 2016, on our consideration of the Plan's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Plan's internal control over financial reporting and compliance.

A handwritten signature in black ink that reads "Eide Bailly LLP". The signature is written in a cursive, flowing style.

Boise, Idaho  
October 19, 2016



## **SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN**

### **Management's Discussion and Analysis**

June 30, 2016

This section presents management's discussion and analysis of the South Dakota Retirement System Supplemental Retirement Plan's (SRP or the Plan) financial position and performance for the year ended June 30, 2016. This section is intended to supplement the SRP financial statements.

#### **Financial Highlights**

- \* The net position available for plan benefits of the SRP increased by \$14.2 million during fiscal year 2016. This increase was primarily attributable to investment gains during the year and contributions outweighing distributions to participants.
- \* The SRP paid \$11.0 million to benefit recipients in fiscal year 2016 compared to \$11.5 million in 2015. The SRP received \$23.6 million in contributions in fiscal year 2016 compared to \$24.2 million in 2015.

#### **Overview of the Financial Statements and Accompanying Information**

The basic financial statements consist of:

##### ***Financial Statements***

The Plan presents the statement of fiduciary net position as of June 30, 2016, and the statement of changes in fiduciary net position for the year then ended. These statements reflect resources available for the payment of benefits as of year-end and sources and uses of those funds during the year.

##### ***Notes to Financial Statements***

The notes to financial statements are an integral part of the financial statements and provide additional detailed information and schedules.

#### **Financial Analysis**

The SRP was established in accordance with Internal Revenue Code Section 457 and under the administrative responsibility of the South Dakota Retirement System Board of Trustees. The Plan is funded by participant contributions and investment income. Marketing and record-keeping services for the Plan are provided by Nationwide Retirement Solutions, Inc.

SRP benefits are based on the participant balances in the Plan.

## **SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN**

### **Management's Discussion and Analysis**

June 30, 2016

A summary of the net position held in trust for plan benefits is shown below:

#### **Summary of Fiduciary Net Position**

June 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Assets:		
Investments, at fair value	\$ 287,446,085	\$ 273,021,545
Cash	49,793	234,865
Accounts receivable	329,270	169,675
Accrued interest	1,285	2,403
Contributions receivable	<u>582,671</u>	<u>742,402</u>
Total assets	288,409,104	274,170,890
Liabilities:		
Accounts payable	<u>27,385</u>	<u>26,216</u>
Net position held in trust for plan benefits	<u><u>\$ 288,381,719</u></u>	<u><u>\$ 274,144,674</u></u>

# SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN

## Management's Discussion and Analysis

June 30, 2016

### Change in Fiduciary Net Position

Additions to the net position include contributions and net investment income. Deductions from net position are primarily benefit payments. During 2016, SRP paid \$11.01 million to benefit recipients, or 4.45% less than 2015.

A summary of the changes in fiduciary net position is shown below:

	2016	2015	Percentage Change
Additions:			
Contributions-employee	\$ 23,644,353	\$ 24,182,730	-2.23%
Investment income	1,978,628	8,705,369	-77.27%
Other income	159,595	(9,453)	-1788.30%
Transfers from related plan	42,262	9,829	100.00%
Total additions	25,824,838	32,888,475	-21.48%
Deductions:			
Distributions to participants	11,011,503	11,524,244	-4.45%
Administrative expenses	576,290	546,632	5.43%
Total deductions	11,587,793	12,070,876	-4.00%
Net change in net position	14,237,045	20,817,599	-31.61%
Plan net position held in trust for plan benefits:			
Beginning of year	274,144,674	253,327,075	8.22%
End of year	\$ 288,381,719	\$ 274,144,674	5.19%

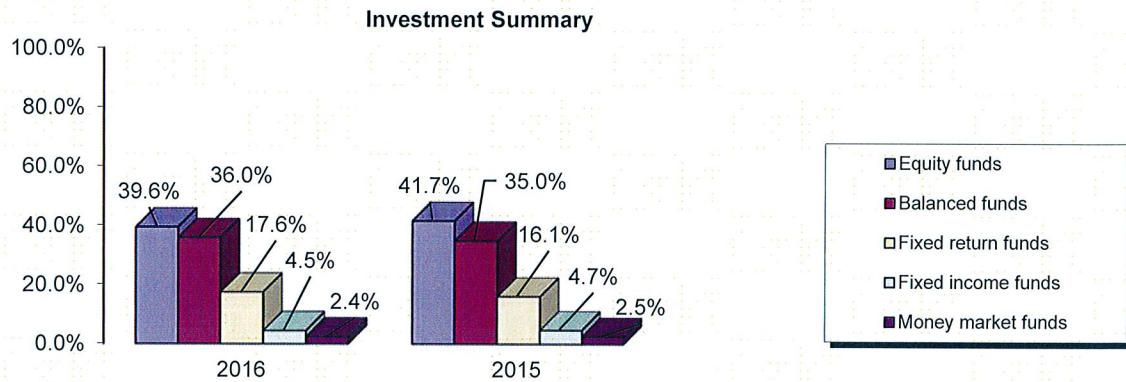
# **SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN**

## **Management's Discussion and Analysis**

June 30, 2016

### **Investments**

The selection of SRP investment portfolio alternatives is the statutory responsibility of the South Dakota Investment Officer. The following exhibit indicates the percentage of investment in each of the SRP fund types.



### **Requests for Information**

Requests for information about the SRP may be directed to the Supplemental Retirement Plan at 207 East Capitol Avenue, P.O. Box 944, Pierre, SD 57501. You may reach the SRP at (605) 224-2230, 1 (800) 959-4457, or online at [www.srp457.com](http://www.srp457.com). You may link to the SRP Web site from the SDRS Web site at [www.state.sd.us/sdrs/](http://www.state.sd.us/sdrs/).

# **SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN**

## **Statement of Fiduciary Net Position**

**June 30, 2016**

### **Assets:**

#### **Investments, at fair value:**

Equity funds	\$ 113,693,796
Balanced funds	103,449,246
Fixed return funds	50,449,641
Fixed income funds	12,912,490
Money market funds	<u>6,940,912</u>

Total investments, at fair value	287,446,085
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Cash	49,793
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Accounts receivable	329,270
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Accrued interest	1,285
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Contributions receivable	<u>582,671</u>
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Total assets	288,409,104
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### **Liabilities:**

Accounts payable	<u>27,385</u>
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Plan net position held in trust for plan benefits	<u><u>\$ 288,381,719</u></u>
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See accompanying notes to financial statements.

# **SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN**

## **Statement of Changes in Fiduciary Net Position**

**Year Ended June 30, 2016**

**Additions:**

Contributions-employee	\$ 23,644,353
Investment income	1,978,628
Other income	159,595

Transfers from related plan	<u>42,262</u>
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Total additions	<u>25,824,838</u>
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**Deductions:**

Distributions to participants	11,011,503
Administrative expenses	<u>576,290</u>

Total deductions	<u>11,587,793</u>
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Net increase in plan net position	14,237,045
-----------------------------------	------------

**Plan net position held in trust for plan benefits**

Beginning of year	<u>274,144,674</u>
-------------------	--------------------

End of year	<u><u>\$ 288,381,719</u></u>
-------------	------------------------------

See accompanying notes to financial statements.

# **SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN**

## **Notes to Financial Statements**

June 30, 2016

### **(1) Plan Description**

The following description of the South Dakota Retirement System Supplemental Retirement Plan (the Plan) provides only general information. Participants should refer to the plan provisions for a more complete description of the Plan.

#### **(a) General**

The Plan was established in July 1987 in accordance with Internal Revenue Code Section 457 under the administrative responsibility of the South Dakota Retirement System Board of Trustees. The state of South Dakota is a participating unit and every political subdivision thereof may become a participating unit in the Plan. The Plan consists of 19,031 participants and 342 employers. The Plan permits employees of participating units to defer a portion of their salary until future years. The deferred compensation is not available to the participants until termination, retirement, death, or unforeseeable emergency.

All amounts of compensation deferred under the Plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights held by the fund, at all times until made available to a participant or the participant's beneficiary, shall be held in trust for the exclusive benefit of the participant.

#### **(b) Contributions**

Participants of the Plan may contribute an amount of not less than \$25 per month and not in excess of \$18,000 for calendar year 2016 or 100% of includable compensation. A participant may make a one-time election to defer an additional amount of twice the otherwise applicable limit during any of the three calendar years immediately preceding a participant's elected normal retirement age. If age 50 or over, participants may also defer additional contributions of \$6,000.

There is a special catch-up provision that allows a participant for three years prior to the normal retirement age to contribute the lesser of

- Twice the annual limit (\$36,000 in 2016) or
- The basic annual limit plus the amount of the basic limit not used in prior years (only allowed if not using age 50 or over catch-up contributions)

#### **(c) Participant's Account**

Each participant's account is credited with the participant's contributions, an allocation of the investment earnings or losses, and administrative expenses. Allocations are made based on the participant's percentage of the total investment balance. The benefit to which a participant is entitled is the benefit that can be provided from the participant's account.

#### **(d) Distribution to Participants**

Distributions of benefits to participants can be made upon termination, retirement, death, or unforeseeable emergency. Distributions are in the form of a lump-sum payment in cash equal to the value of the funds allocated to their account or installments, as defined in the plan agreement.

## **SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN**

### **Notes to Financial Statements**

June 30, 2016

**(e) Vesting**

Participants are vested immediately in their contributions plus actual earnings thereon.

**(f) Transfers from Related Plan**

During the year, net assets of \$42,262 were transferred into the Plan from the South Dakota Retirement Special Pay Plan (SPP), a related plan. Transfers between SRP and SPP are allowed under state statutes.

**(2) Summary of Significant Accounting Policies**

**(a) Basis of Accounting**

The accompanying financial statements are prepared using the accrual basis of accounting. Revenue is recorded when earned and expenses recorded when incurred. Employee contributions are recognized when due pursuant to formal commitment, as well as statutory requirements. Distributions to participants are recognized when paid in accordance with the terms of the Plan.

**(b) Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires the plan administrator to make estimates and assumptions that affect the reported amounts of assets and liabilities, and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

**(c) New GAAP Implementation**

In fiscal year 2016, SRP implemented Government Accounting Standards Board Statement No. 72, Fair Value Measurement and Application. GASB 72 addresses accounting and financial reporting issues related to fair value measurements and guidance for financial reporting purposes. There was no material impact on valuation inputs used to measure fair value as a result of the implementation of GASB 72.

**(3) Investments**

Investments are reported at fair value, in accordance with GASB Statement No. 72. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GASB 72 sets forth the framework for measuring value. The framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels. The three levels of the fair value hierarchy under GASB 72 are described as follows:

Level 1 – Valuation inputs are quoted prices in active markets for identical asset or liability as of the measurement date.



# SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN

## Notes to Financial Statements

June 30, 2016

Level 2 – Valuation inputs other than quoted prices included within Level 1 that are observable for an asset or liability, either directly or indirectly.

Level 3 – Valuation inputs are based on significant unobservable inputs for an asset or liability.

As a practical expedient, GASB 72 allows the net asset value (NAV) or its equivalent to be used when a readily determinable fair value is not available. The NAV valuations are based on valuations of the underlying companies as determined and reported by the fund manager or general partner and are excluded from the fair value hierarchy.

	<b>Fair Value</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Mutual funds	\$ 236,998,262	\$ 236,998,262	\$ -	\$ -
Fixed income funds	50,447,823	50,447,823		
Investments at fair value	<u>\$ 287,446,085</u>	<u>\$ 287,446,085</u>	<u>\$ -</u>	<u>\$ -</u>

Fair value for the mutual funds is determined based on the value of the underlying assets in the portfolio. Fixed return funds are carried at contract value, which approximates fair value.

Money market funds invest in short-term, interest-bearing instruments consisting of Treasury Bills, certificates of deposit, and commercial paper. Fixed income funds invest in interest-bearing instruments with varying maturities, including government or corporate bonds, notes, bills, and debentures. Equity funds invest in common and preferred stock and convertible securities of United States and foreign corporations. Balanced funds are invested in a combination of short-term, fixed income, and equity instruments. Fixed return funds are invested in an insurance company group annuity.

The interest rate on fixed return funds is set each quarter and guaranteed for up to two years. These funds are subject to certain restrictions. No more than 20% of the beginning of the year aggregate fixed return fund balance may be transferred annually to another investment alternative.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Investments denominated in foreign currencies are translated into USD using the year-end spot foreign currency exchange rates. Foreign exchange rate gains and losses are included with the net appreciation in fair value of investments.

# SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN

## Notes to Financial Statements

June 30, 2016

Changes in fiduciary net position for the year ended June 30, 2016 by investment alternatives available to participants were as follows:

	Beginning balance	Contributions	Investment Income	Additions/ Deductions	Ending balance	Market value as a percentage of plan assets
Money Market						
Vanguard Prime Reserve	\$ 6,863,821	\$ 476,633	\$ 2,260	\$ (7,342,714)	\$ -	0.00%
Vanguard Federal Money Market	-	601,683	10,204	6,329,025	6,940,912	2.41%
	6,863,821	1,078,316	12,464	(1,013,689)	6,940,912	2.41%
Fixed Return:						0.00%
Prudential	43,719,402	3,286,627	1,386,864	2,056,747	50,449,640	17.49%
Fixed Income						0.00%
Vanguard Bond Market	12,876,968	582,096	751,847	(1,298,421)	12,912,490	4.48%
Balanced						0.00%
* Vanguard Target Ret Inc Fund	6,062,220	158,229	176,903	(941,263)	5,456,089	1.89%
* Vanguard Target Ret 2010 Fund	6,665,879	83,331	160,289	(1,128,974)	5,780,525	2.00%
* Vanguard Target Ret 2015 Fund	16,332,943	999,248	303,188	(1,661,712)	15,973,667	5.54%
* Vanguard Target Ret 2020 Fund	21,442,789	2,506,685	339,190	(1,036,462)	23,252,202	8.06%
* Vanguard Target Ret 2025 Fund	15,484,826	2,388,632	173,083	(673,318)	17,373,223	6.02%
* Vanguard Target Ret 2030 Fund	11,032,570	1,821,482	49,762	(143,168)	12,760,646	4.42%
* Vanguard Target Ret 2035 Fund	5,780,493	1,110,086	(7,428)	9,681	6,892,832	2.39%
* Vanguard Target Ret 2040 Fund	4,136,559	949,477	(42,199)	(224,559)	4,819,278	1.67%
* Vanguard Target Ret 2045 Fund	3,609,130	1,136,581	(25,719)	(49,564)	4,670,428	1.62%
* Vanguard Target Ret 2050 Fund	3,941,098	1,066,574	(42,498)	(229,648)	4,735,526	1.64%
* Vanguard Target Ret 2055 Fund	900,984	561,120	1,812	2,805	1,466,721	0.51%
* Vanguard Target Ret 2060 Fund	141,101	105,934	1,617	19,457	268,109	0.09%
						0.00%
Total Balanced	95,530,592	12,887,379	1,088,000	(6,056,725)	103,449,246	35.87%
Equity						0.00%
* Mutual Shares	15,774,300	449,060	(361,686)	(1,409,141)	14,452,533	5.01%
* Windsor II Admiral	25,601,701	798,356	(281,344)	(1,446,781)	24,671,932	8.56%
* Vanguard Instit Index	30,192,593	1,345,329	1,154,479	(2,037,115)	30,655,286	10.63%
* Vanguard Tot Intl Stock Ind	7,719,093	450,329	(700,913)	(620,285)	6,848,224	2.37%
* Dodge Cox Global Stock	1,029,724	87,969	(107,217)	(77,421)	933,055	0.32%
* Dodge & Cox Int Stock Fnd	2,130,455	195,155	(400,239)	(186,740)	1,738,631	0.60%
* Growth Fund of America	7,287,400	737,156	102,261	(65,078)	8,061,739	2.80%
* Capital World Grth & Inc	3,965,262	478,027	(121,533)	(57,146)	4,264,610	1.48%
* Vanguard Small Cap Index Fd AS	1,319,840	324,044	(28,256)	97,270	1,712,898	0.59%
* Vanguard Ext Mkt Idx Inst	12,151,751	745,208	(654,725)	(547,510)	11,694,724	4.06%
* Vanguard Wlsly Inc Adml	2,547,125	552,209	321,031	844,062	4,264,427	1.48%
* Vanguard Strategic Equity	4,311,518	477,606	(183,675)	(209,712)	4,395,737	1.52%
						0.00%
Total Equity	114,030,762	6,640,448	(1,261,817)	(5,715,597)	113,693,796	39.42%
						0.00%
Total Investments	273,021,545	24,474,866	1,977,358	(12,027,685)	287,446,084	99.68%
Other Net Assets	1,123,129	(830,513)	159,697	483,322	935,635	0.32%
						0.00%
Total plan assets	\$ 274,144,674	\$ 23,644,353	\$ 2,137,055	\$ (11,544,363)	\$ 288,381,719	100.00%

Investments in bold represent investments exceeding 5% or more of net position as of June 30, 2016. Investments with an asterisk (\*) represent investments with international mutual funds.

# SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN

## Notes to Financial Statements

June 30, 2016

### *Risks and Uncertainties*

The Plan invests in various investment securities. These securities are exposed to various risks, such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect participants' account balances and the amounts reported in the statement of fiduciary net position. Since all investments are participant directed, all risks exist at the participant level. Each individual within the plan has the responsibility for managing their exposure to fair value loss.

#### *(a) Interest Rate Risk*

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The portfolios of the SDRS Supplemental Retirement Plan are benchmarked to the duration of the International Index and must fall between 70% and 130% of the duration.

As of June 30, 2016, the plan had the following investments and maturities in its fixed income investment and certain mutual funds which include investments in bonds. The durations of the various investment types are listed in the following table:

			Fair Value	Weighted Average Maturity (Years)	Credit Quality
Fixed Income					
	VBTI	Vanguard Bond Market	\$12,425,689	8.00	AA
Balanced					
	VTIN	Vanguard Target Ret Inc Fund	3,487,532	7.20	AA
	VTEN	Vanguard Target Ret 2010 Fund	3,582,769	7.24	AA
	VTXV	Vanguard Target Ret 2015 Fund	7,883,005	7.55	AA
	VTWN	Vanguard Target Ret 2020 Fund	9,305,531	8.19	AA
	VTTV	Vanguard Target Ret 2025 Fund	5,635,874	8.40	A
	VTHR	Vanguard Target Ret 2030 Fund	3,257,793	8.39	A
	VTTH	Vanguard Target Ret 2035 Fund	1,271,038	8.39	A
	VFOR	Vanguard Target Ret 2040 Fund	546,024	8.39	A
	VTIV	Vanguard Target Ret 2045 Fund	446,493	8.39	A
	VFIF	Vanguard Target Ret 2050 Fund	452,243	8.39	AA
	VFFV	Vanguard Target Ret 2055 Fund	140,365	8.39	AA
	VTTTS	Vanguard Target Ret 2060 Fund	25,604	8.38	AA
	VWIA	Vanguard Wellsley Inc Adml	2,497,248	10.10	A

## SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN

### Notes to Financial Statements

June 30, 2016

#### **(b) Credit Risk**

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. As of June 30, 2016, the portfolios held the following investments, excluding those issued by or explicitly guaranteed by the U.S. government, which are not considered to have credit risk. The investments are grouped as rated by Moody's Investors Service.

	<u><b>Fair value</b></u>
Moody's rating:	
Aa	\$ 37,302,738
A	13,654,470
Unrated	<u>676,351</u>
Total	<u><u>\$ 51,633,559</u></u>

#### **(c) Concentration of Credit Risk**

Concentration of credit risk is the risk of loss attributed to the magnitude of the plan's investment in a single issuer. The plan's investments are managed by several fund managers. The concentration of investments are determined by the participants' elections to invest in available investments options as selected by the SD Investment Council. The investments that exceed 5% are identified in bold on page 51.

#### **(d) Foreign Currency Risk**

Foreign currency risk is the risk that changes in exchange rates could adversely affect the fair value of the investment. The plan allows the option of investments in mutual funds of countries outside the U.S. that invest in securities not required to disclose the individual assets within the fund. The fair value of these investments was \$42,952,715 as of June 30, 2016. International mutual funds are marked with asterisk on page 51.

#### **(4) Plan Administration**

Nationwide Retirement Solutions, Inc. (NRS) of Columbus, Ohio, is the private sector administrator and marketing agent of the Plan. NRS provides various accounting, reporting, and marketing services and receives compensation through maintenance and asset fees charged against each participant account.

#### **(5) Federal Income Tax Status**

The Plan is an eligible nonqualified deferred compensation plan under Section 457(a) of the Internal Revenue Code and is exempt from federal income taxes. The Plan has received a favorable determination letter dated September 15, 1988. The Plan has been amended since receiving the determination letter. However, the plan administrator and the Plan's tax counsel believe that the Plan is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code. Therefore, no provision for income taxes has been included in the Plan's financial statements.

## **SOUTH DAKOTA RETIREMENT SYSTEM SUPPLEMENTAL RETIREMENT PLAN**

### **Notes to Financial Statements**

June 30, 2016

#### **(6) Plan Termination**

Although they have not expressed any intent to do so, the South Dakota Retirement Board of Trustees and the South Dakota Legislature have the right to terminate the Plan. In the event of plan termination, participants continue to be 100% vested in their account balances.

**Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance  
and Other Matters Based on an Audit of Financial Statements Performed in Accordance with  
*Government Auditing Standards***

To the Board of Trustees  
South Dakota Retirement System  
Pierre, South Dakota

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the South Dakota Retirement System Supplemental Retirement Plan (SRP), as of and for the year ended June 30, 2016, and the related notes to the financial statements, and have issued our report thereon dated October 19, 2016.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered SRP's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of SRP's internal control. Accordingly, we do not express an opinion on the effectiveness of the SRP's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or, significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether SRP's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

**Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

A handwritten signature in black ink that reads "Eide Sully LLP". The signature is written in a cursive, flowing style.

Boise, Idaho  
October 19, 2016



Financial Statements  
June 30, 2016

# South Dakota Retirement System Special Pay Plan





CPAs & BUSINESS ADVISORS

## Independent Auditor's Report

To the Board of Trustees  
South Dakota Retirement System  
Pierre, South Dakota

### Report on the Financial Statements

We have audited the accompanying financial statements of the South Dakota Retirement System Special Pay Plan (SPP or the Plan), which comprise the statement of fiduciary net position as of June 30, 2016, and the related statement of changes in fiduciary net position, for the year then ended, and the related notes to the financial statements.

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective statement of fiduciary net position of the South Dakota Retirement System Special Pay Plan, as of June 30, 2016, and the respective statement of changes in fiduciary net position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

**Other Matters****Required Supplementary Information**

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 59-62 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated October 19, 2016, on our consideration of the Plan's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Plan's internal control over financial reporting and compliance.

A handwritten signature in cursive script that reads "Eide Bailly LLP".

Boise, Idaho  
October 19, 2016

## **SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN**

### **Management's Discussion and Analysis**

June 30, 2016

This section presents management's discussion and analysis of the South Dakota Retirement System Special Pay Plan's (SPP or the Plan) financial position and performance for the year ended June 30, 2016. This section is intended to supplement the SPP financial statements and notes.

#### **Financial Highlights**

- The net position available for plan benefits of the SPP increased by \$5.1million during fiscal year 2016. This increase was primarily attributable to additional participant contributions and investment gains.
- The SPP paid \$5.3 million to benefit recipients in fiscal year 2016 compared to \$5.9 million in 2015. The SPP received \$9.3 million in contributions in fiscal year 2016 compared to \$9.8 million in 2015.

#### **Overview of the Financial Statements and Accompanying Information**

The basic financial statements consist of:

##### ***Financial Statements***

The Plan presents the statement of fiduciary net position as of June 30, 2016, and the statement of changes in fiduciary net position for the year then ended. These statements reflect resources available for the payment of benefits as of year-end and sources and uses of those funds during the year.

##### ***Notes to Financial Statements***

The notes to financial statements are an integral part of the financial statements and provide additional detailed information and schedules.

#### **Financial Analysis**

The SPP was established in accordance with Internal Revenue Code Section 401 and under the administrative responsibility of the South Dakota Retirement System Board of Trustees. The Plan is funded by participant contributions and investment income. Marketing and record-keeping services for the Plan are provided by Nationwide Retirement Solutions, Inc.

SPP benefits are based on the participant balances in the Plan.

## **SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN**

### **Management's Discussion and Analysis**

June 30, 2016

A summary of the net position held in trust for plan benefits is shown below:

#### **Summary of Fiduciary Net Position**

June 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Assets:		
Investments, at fair value	\$ 45,001,318	\$ 40,831,435
Cash	8,290	11,160
Revenue sharing receivable	63,118	916
Accrued interest	241	145
Contributions receivable	<u>1,541,526</u>	<u>631,543</u>
Total assets	46,614,493	41,475,199
Liabilities:		
Accounts payable	<u>12,343</u>	<u>14,817</u>
Plan net position held in trust for plan benefits	<u><u>\$ 46,602,150</u></u>	<u><u>\$ 41,460,382</u></u>

# SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN

## Management's Discussion and Analysis

June 30, 2016

### Changes in Fiduciary Net Position

Additions to the net position mainly were due to contributions during the year. Deductions from net position are primarily benefit payments and administrative expenses. During 2016, SPP paid \$5.3 million to benefit recipients, or 10.22% less than 2015.

A summary of the changes in fiduciary net position is shown below:

	2016	2015	Percentage Change
Additions:			
Contributions-employee	\$ 9,344,058	\$ 9,759,000	-4.25%
Investment income	1,098,669	1,091,068	0.70%
Other income	92,261	30,028	207.25%
Total additions	<u>10,534,988</u>	<u>10,880,096</u>	-3.17%
Transfers to related plan	<u>42,262</u>	<u>9,829</u>	100.00%
Deductions:			
Distributions to participants	5,253,692	5,851,781	-10.22%
Administrative expenses	97,266	86,467	12.49%
Total deductions	<u>5,393,220</u>	<u>5,948,077</u>	-9.33%
Net change in plan net position	<u>5,141,768</u>	<u>4,932,019</u>	4.25%
Plan net position held in trust for plan benefits:			
Beginning of year	<u>41,460,382</u>	<u>36,528,363</u>	13.50%
End of year	<u><u>\$ 46,602,150</u></u>	<u><u>\$ 41,460,382</u></u>	12.40%

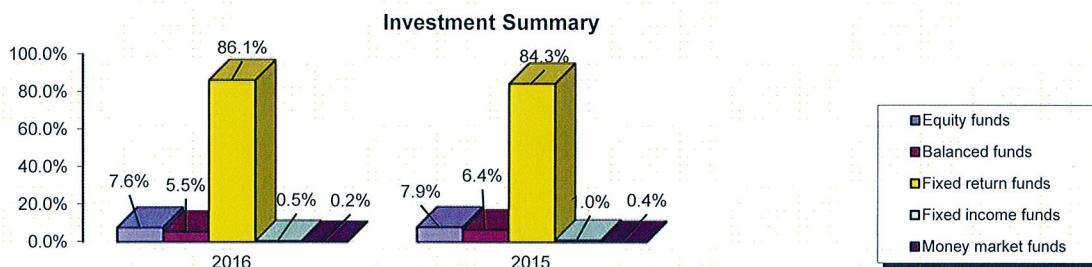
# SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN

## Management's Discussion and Analysis

June 30, 2016

### Investments

The selection of SPP investment portfolios alternatives is the statutory responsibility of the South Dakota Investment Officer. The following exhibit indicates the percentage of investment in each of the SPP fund types.



### Requests for Information

Requests for information about the SPP may be directed to the Special Pay Plan at 207 East Capitol Avenue, P.O. Box 944, Pierre, SD 57501. You may reach the SPP at (605) 224-2230 or 1 (800) 959-4457.

# **SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN**

## **Statement of Fiduciary Net Position**

**June 30, 2016**

### **Assets:**

#### **Investments, at fair value:**

Equity funds	\$ 3,433,399
Balanced funds	2,489,973
Fixed return funds	38,750,615
Fixed income funds	238,267
Money market funds	<u>89,064</u>

Total investments, at fair value 45,001,318

Cash 8,290

Revenue sharing receivable 63,118

Accrued interest 241

Contributions receivable 1,541,526

Total assets 46,614,493

### **Liabilities:**

Accounts payable 12,343

Net position held in trust for plan benefits \$ 46,602,150

See accompanying notes to financial statements.

# **SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN**

## **Statement of Changes in Fiduciary Net Position**

**Year Ended June 30, 2016**

**Additions:**

Contributions-employee	\$ 9,344,058
Investment income	1,098,669
Other income	<u>92,261</u>

Total additions	<u>10,534,988</u>
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Transfers to related plan	<u>42,262</u>
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**Deductions:**

Distributions to participants	5,253,692
Administrative expenses	<u>97,266</u>

Total deductions	<u>5,393,220</u>
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Net increase in plan net position	5,141,768
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**Net position held in trust for plan benefits:**

Beginning of year	<u>41,460,382</u>
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End of year	<u><u>\$ 46,602,150</u></u>
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See accompanying notes to financial statements.



## **SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN**

### **Notes to Financial Statements**

June 30, 2016

#### **(1) Plan Description**

The following description of the South Dakota Retirement System Special Pay Plan (the Plan) provides only general information. Participants should refer to the plan provisions for a more complete description of the Plan.

##### **(a) General**

The Plan was established in July 2004 as a qualified plan pursuant to Internal Revenue Code Section 401(a) under the administrative responsibility of the South Dakota Retirement System Board of Trustees. South Dakota state government and the South Dakota Board of Regents are participating units and every state political subdivision may become a participating unit in the Plan. The Plan consists of 2,893 participants and 126 employers. The Plan mandates that qualifying employees (over age 55 and \$600 or more in special pay) of participating units defer 100% of their special lump-sum termination pay to the plan. Special pay is compensation other than regular salary or wages granted to a member of the South Dakota Retirement System and transferred in a sum to the Plan at termination of the member's employment. The participating unit transfers the deferred pay to the fund. This deferred pay is available to a participant immediately after termination, upon later retirement, or to beneficiaries or an estate upon the participant's death.

All amounts of special termination pay deferred under the Plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights held by the fund, at all times until made available to a participant or the participant's beneficiary for estate, shall be held in trust for the exclusive benefit of the participant.

##### **(b) Contributions**

Participants in the Plan can contribute the lesser of 100% of their one-time, lump-sum special pay associated with their termination or \$53,000 for calendar year 2016.

##### **(c) Participant's Account**

Each participant's account is credited with the participant's contribution, an allocation of the investment earnings or losses, and administrative expenses. Allocations are made based on the participant's percentage of the total investment balance. The benefit to which a participant is entitled is the benefit that can be provided from the participant's account.

##### **(d) Distribution to Participants**

Distributions of benefits to participants can be made immediately after the participant's termination, or upon the participant's retirement, or to a beneficiary or an estate upon the participant's death. Distributions are in the form of a lump-sum payment in cash equal to the value of the funds allocated to their account or in the form of installments as defined in the plan agreement.

##### **(e) Transfers from Related Plan**

During the year, assets of \$42,262 were transferred into the Supplemental Retirement Plan from the South Dakota Retirement Special Pay Plan (SPP), a related plan. Transfers between SRP and SPP are allowed under state statutes.

# **SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN**

## **Notes to Financial Statements**

June 30, 2016

### ***(f) Risks and Uncertainties***

The Plan invests in various investment securities. These securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect participants' account balances and the amounts reported in the statement of fiduciary net position.

## **(2) Summary of Significant Accounting Policies**

### ***(a) Basis of Accounting***

The accompanying financial statements are prepared using the accrual basis of accounting. Revenue is recorded when earned and expenses recorded when incurred. Employee contributions are recognized when due pursuant to formal commitment, as well as statutory requirements. Distributions to participants are recognized when paid in accordance with the terms of the Plan.

### ***(b) Use of Estimates***

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires the plan administrator to make estimates and assumptions that affect the reported amounts of assets and liabilities, and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

## **(3) Investments**

Investments are reported at fair value, in accordance with GASB Statement No. 72. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GASB 72 sets forth the framework for measuring value. The framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels. The three levels of the fair value hierarchy under GASB 72 are described as follows:

Level 1 – Valuation inputs are quoted prices in active markets for identical asset or liability as of the measurement date.

Level 2 – Valuation inputs other than quoted prices included within Level 1 that are observable for an asset or liability, either directly or indirectly.

Level 3 – Valuation inputs are based on significant unobservable inputs for an asset or liability.

As a practical expedient, GASB 72 allows the net asset value (NAV) or its equivalent to be used when a readily determinable fair value is not available. The NAV valuations are based on valuations of the underlying companies as determined and reported by the fund manager or general partner and are excluded from the fair value hierarchy.

# SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN

## Notes to Financial Statements

June 30, 2016

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Mutual funds	\$ 6,250,703	\$ 6,250,703	\$ -	\$ -
Fixed income funds	38,750,615	38,750,615		
Investments at fair value	<u>45,001,318</u>	<u>45,001,318</u>	<u>-</u>	<u>-</u>

Fair value for the mutual funds is determined based on the value of the underlying assets in the portfolio. Fixed return funds are carried at contract value, which approximates fair value.

Money market funds invest in short-term, interest-bearing instruments consisting of Treasury Bills, certificates of deposit, and commercial paper. Fixed income funds invest in interest-bearing instruments with varying maturities, including government or corporate bonds, notes, bills, and debentures. Equity funds invest in common and preferred stock and convertible securities of United States and foreign corporations. Balanced funds are invested in a combination of short-term, fixed income, and equity instruments. Fixed return funds are invested in an insurance company group annuity.

The interest rate on fixed return funds is set each quarter and guaranteed for up to two years. These funds are subject to certain restrictions. No more than 20% of the beginning of the year aggregate fixed return fund balance may be transferred annually to another investment alternative.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Investments denominated in foreign currencies are translated into USD using the year-end spot foreign currency exchange rates. Foreign exchange rate gains and losses are included with the net appreciation in fairvalue of investments.

# SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN

## Notes to Financial Statements

June 30, 2016

Changes in fiduciary net position for the year ended June 30, 2016 by investment alternatives available to participants were as follows:

	Beginning Balance	Contributions	Investment Income	Transfers In/Out	Additions/ Deductions	Ending Balance	Market Value as a Percentage of Plan Assets
Money Market							
Vanguard Federal	\$ -	\$ 24,376	\$ 117	\$ -	\$ 64,571	\$ 89,064	0.19%
Vanguard Prime Reserve	79,531	-	26	-	(79,557)	-	0.00%
Total Money Market	79,531	24,376	143	-	(14,986)	89,064	0.19%
Fixed Return:							
Prudential	34,848,486	8,064,461	1,058,493	9,829	(5,230,654)	38,750,615	83.15%
Fixed Income							
Vanguard Bond Market	269,813	-	14,307	-	(45,853)	238,267	0.51%
Balanced							
Vanguard Target Ret Inc Fund	272,072	-	7,613	-	(53,445)	226,240	0.49%
Vanguard Target Ret 2010 Fund	748,322	53,000	21,391	-	(27,830)	794,883	1.71%
Vanguard Target Ret 2015 Fund	1,158,630	-	21,400	-	(57,908)	1,122,122	2.41%
Vanguard Target Ret 2020 Fund	168,383	3,552	1,572	(52,091)	60,900	182,316	0.39%
Vanguard Target Ret 2025 Fund	88,184	3,048	748	-	(146)	91,834	0.20%
Vanguard Target Ret 2030 Fund	11,020	-	12	-	(23)	11,009	0.02%
Vanguard Target Ret 2035 Fund	30,159	-	(398)	-	(4,062)	25,699	0.06%
Vanguard Target Ret 2045 Fund	-	254	3	-	-	257	0.00%
Vanguard Target Ret 2050 Fund	36,259	-	(540)	-	(106)	35,613	0.08%
Total Balanced	2,513,029	59,854	51,801	(52,091)	(82,620)	2,489,973	5.34%
Equity							
Dodge and Cox Int Stock Fd	43,145	-	(7,940)	-	(12,313)	22,892	0.05%
DodgeCox Global Stock	14,597	65,041	(5,683)	-	(4,153)	69,802	0.15%
Am Funds Capital	131,997	1,949	(4,133)	-	3,722	133,535	0.29%
Vanguard Ext Mkt Ind Inst	382,419	69,360	(24,377)	-	15,587	442,989	0.95%
Growth Fund of America	547,178	19,283	14,373	-	(14,255)	566,579	1.22%
Mutual Shares	405,603	768	(8,678)	-	(15,564)	382,129	0.82%
Windsor II Admiral	292,518	3,509	(2,307)	-	(5,671)	288,049	0.62%
Vanguard Small Cap Indx Fd AS	132,318	-	(8,305)	-	(29,272)	94,741	0.20%
Vanguard Instit Index	622,157	122,614	33,638	-	5,595	784,004	1.68%
Vanguard Tot Intl Stock Ind	163,372	-	(14,869)	-	(1,039)	147,464	0.32%
Vanguard Wlsly Inc Adml	121,563	-	18,326	-	172,249	312,138	0.67%
Vanguard Strategic Equity	263,709	2,860	(16,361)	-	(61,131)	189,077	0.41%
Total Equity	3,120,576	285,384	(26,316)	-	53,755	3,433,399	7.37%
Total Investments	40,831,435	8,434,075	1,098,428	(42,262)	(5,320,358)	45,001,318	96.56%
Other Assets	628,947	909,983	62,442	-	(540)	1,600,832	3.44%
Net position held in trust for plan benefits	\$ 41,460,382	\$ 9,344,058	\$ 1,160,870	\$ (42,262)	\$ (5,320,898)	\$ 46,602,150	100.00%

## **SOUTH DAKOTA RETIREMENT SYSTEM SPECIAL PAY PLAN**

### **Notes to Financial Statements**

June 30, 2016

**(4) Plan Administration**

Nationwide Retirement Solutions, Inc. (NRS) of Columbus, Ohio, is the private sector administrator and marketing agent of the Plan. NRS provides various accounting, reporting, and marketing services and receives compensation through maintenance and asset fees charged against each participant account.

**(5) Federal Income Tax Status**

The Plan is a qualified plan under Section 401(a) of the Internal Revenue Code and is exempt from federal income taxes. The Plan has received a favorable determination letter dated October 28, 2004. The Plan has been amended since receiving the determination letter. However, the plan administrator and the Plan's tax counsel believe that the Plan is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code. Therefore, no provision for income taxes has been included in the Plan's financial statements.

**(6) Plan Termination**

Although they have not expressed any intent to do so, the South Dakota Retirement Board of Trustees and the South Dakota Legislature have the right to terminate the Plan. In the event of plan termination, participants would continue to be 100% vested in their account balances.

**Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance  
and Other Matters Based on an Audit of Financial Statements Performed in Accordance with  
*Government Auditing Standards***

To the Board of Trustees  
South Dakota Retirement System  
Pierre, South Dakota

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the South Dakota Retirement System Special Pay Plan (SPP), as of and for the year ended June 30, 2016, and the related notes to the financial statements, and have issued our report thereon dated October 19, 2016.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered SPP's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of SPP's internal control. Accordingly, we do not express an opinion on the effectiveness of the SPP's internal control.

*A deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or, significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether SPP's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the

determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

**Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

A handwritten signature in black ink that reads "Eide Sully LLP". The signature is written in a cursive, flowing style.

Boise, Idaho  
October 19, 2016